Task Force on the Future of the Canadian Financial Services Sector

Competition Policy Issues

by
Donald G. McFetridge

September 1998

Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector

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The views expressed in these research papers are those of the authors and do not necessarily reflect the views of the Task Force on the Future of the Canadian Financial Services Sector

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I. Introduction and Framework

The purpose of this study is to assess the efficacy of the institutions of competition law and policy in dealing with competition issues in the financial services industry. The study assesses the ability of these institutions to make the appropriate decision regarding bank mergers in the event they are otherwise allowed to occur. This presumes some change in the existing policy environment. It does not constitute a recommendation that this environment be changed. In particular, to contemplate the possibility of the assessment of a merger between two of the big six banks by the Competition Bureau and, possibly the Competition Tribunal, is to assume that the policy of the Department of Finance and the Schedule I bank ownership rules are such that a merger would be possible. It is not a statement that the ten percent ownership rule *should* be changed. In general, this study examines how competition law applies or would apply within the *existing* regulatory environment.

Of course, there may be instances in which competition law would be more effective if some regulations were changed. There may also be instances in which competition law is not the preferred instrument and a regulatory change would be a more effective way of ensuring market performance. For example, in many industries, trade liberalization and elimination of regulatory restrictions on entry is the best competition policy. This study would be remiss if it did not point that out.

This study draws conclusions regarding the effectiveness of the Competition Act as an instrument for encouraging competition via both merger review and the control of anticompetitive conduct. There are four issues here. The first is whether the Competition Bureau, the Competition Tribunal and the courts have been effective in dealing with competition issues in general since the Competition Act was amended in 1986. The second issue is whether these institutions have been or are likely to be effective in dealing with competition issues in the financial services industry. The third issue is whether there are process improvements or statutory changes that the Task Force might recommend that could make the existing institutions more effective especially as they relate to the encouragement of competition in the financial services industry. The fourth issue is whether the effectiveness of the institutions of competition law and policy would be materially enhanced either by the participation of a specialized financial industry competition regulator in the process and/or by the insertion of provisions in the Competition Act or other statutes relating to competition in the financial services industry.

At present, the Competition Bureau and the Minister of Finance both exercise jurisdiction over competition in the financial services industry. This has raised the question of whether it would be preferable to have competition issues adjudicated solely by a specialized financial services industry regulator or solely by a general competition regulator or by a combination of the two. It is important to understand that to conclude that the Competition Bureau should have sole jurisdiction over competition issues is not to conclude that there will be or should be any mergers among Schedule I banks. That would be a matter for the Competition Bureau and Competition Tribunal. This report describes how these institutions would likely analyze the competition issues involved. It highlights contentious issues. It does not anticipate the conclusions they might reach in a particular fact situation.

In the event that the existing institutions of competition law are given ultimate authority over competition matters in the financial services industry, there remains the issue of interface with both the prudential regulator and any regulatory overseer of such other non-competition issues as foreign investment and employment. While this report expresses some views on these issues, it does not address in detail the question of which, if any, forms of non-competition. regulatory oversight should exist and how they should interface with the competition authorities.

This study has nine major analytical components. Conclusions are drawn throughout the text and are also pulled together at the end of the study. The topics covered in the study are as follows:

- merger review in Canada
- the Competition Bureau's proposed approach to bank merger review in Canada
- bank merger review in the United States
- bank merger review in Australia
- bank merger review in the United Kingdom
- studies of the exercise of market power in the financial services industry
- efficiencies issues in the financial services industry
- vertical restrictions in the context of the financial services industry
- abuse of dominant position in the context of the financial services industry.

II. Merger Review in Canada

The Merger Provisions of the Competition Act

The *Competition Act* provides for civil review of mergers by the Competition Tribunal which is comprised of lay persons and federal court judges. On application by the Director of Investigation and Research (the federal government official responsible for the enforcement of the *Competition Act*), the Competition Tribunal may issue a prohibition or divestiture order with respect to a merger which it deems likely to prevent or lessen competition substantially.

The *Competition Act* has three provisions with regard to mergers which distinguishes it from the statutes of other countries. First, the Tribunal may not reach a conclusion that a merger is likely to prevent or lessen competition substantially solely on the basis of market share or concentration evidence (S.92(2)). Second, in its determination of whether a merger is likely to prevent or lessen competition substantially, the Tribunal is obliged to consider structure and conduct factors such as the extent of foreign competition, whether either of the parties is likely to fail, the availability of acceptable substitutes, barriers to entry, the extent of remaining competition, whether the merger eliminates a particularly vigorous competitor and the extent of change and innovation in the market (S.93). Third, in the event that the Tribunal finds that a merger is likely to prevent or lessen competition substantially, the merging firms have recourse to an affirmative efficiencies defence under Section 96 of the *Act*. Section 96 directs the Tribunal to decline to issue a prohibition or divestiture order sought by the Director if the efficiency gains forgone as a consequence would be greater than and offset the effects of the prevention or lessening of competition involved.

The Merger Enforcement Guidelines

In 1991, the Director of Investigation and Research (the Director) issued guidelines as to how he intended to interpret the merger provisions of the *Competition Act*.[1] These guidelines are broadly similar to the United States Department of Justice/Federal Trade Commission *Horizontal Merger Guidelines*.[2] The *Merger Enforcement Guidelines* adopt the hypothetical monopolist approach to geographic and product market definition (§3).[3] They define safe harbours of a market share under 35 percent for the unilateral exercise of market power and a four firm concentration ratio under 65 percent or a market share under 10 percent for the interdependent exercise of market power (§4.2). Interdependent exercise of market power is regarded as being more likely when conditions of sale (pricing, discounts, delivery charges, product characteristics) in the relevant market are transparent (i.e. readily observable by competitors) (§4.10.1). Interdependent exercise

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[1]Director of Investigation and Research, Competition Act, *Merger Enforcement Guidelines* (Supply and Services Canada, 1991)

[2]United States Department of Justice Antitrust Division / Federal Trade Commission, "1992 Horizontal Merger Guidelines" *Federal Register* 57:41552-41563.

[3]Specifically, the Director defines the relevant market as the smallest group of products and geographic area over which it would be profitable to impose a significant non-transitory price increase. This is defined, in turn, as a 5 percent price increase for a period of a year.

of market power is also considered more likely when the value of the typical sale is small and purchases are frequent and regular (§4.10.2).

Entry barriers are defined to exist if a material price increase would not be defeated by new entrants within two years (§4.6). In assessing entry conditions, emphasis is placed on specialized commitments a new entrant must make (giving rise to sunk costs) and to factors likely to delay effective entry.

The efficiencies defence is interpreted as requiring the merging firms to show that quantifiable efficiency gains which would not likely be realized if the order sought by the Director were issued exceed the quantifiable effects of the lessening of competition and that the non-quantifiable efficiencies (dynamic efficiencies, for example) offset the non-quantifiable effects of the lessening (deteriorating quality of service, for example) (§5.4). The quantifiable effects of the prevention or lessening of competition are defined as the deadweight loss in surplus resulting from the exercise of market power by the merged entity (§5.5). Redistributive effects are ignored.

Merger Enforcement Activity under the Competition Act

Resources Available for Enforcement

The resources available to the Competition Bureau to fulfill its statutory mandate have declined somewhat in recent years. This is reflected in the authorized number of full time equivalent employees of the Bureau:[4]

Fiscal Year	Bureau Full Time Equivalent Staff	Merger Branch FTE Staff
1988-89	258	32
1989-90	261	34
1990-91	261	38
1991-92	261	40
1992-93	274	39
1993-94	266	36
1994-95	244	36
1995-96	242	36

Given limited resources, the Bureau is probably obliged to set enforcement priorities. This presumably involves both the allocation of resources between merger review and other enforcement activities and the allocation of resources among merger cases. It may well be that

[4] These data are reported in W. T. Stanbury, "Roles, Responsibilities and Resources: The Bureau of Competition Policy's Budget and Its Activities" (Faculty of Commerce and Business Administration, University of British Columbia, 1996) Table 4.

the Bureau might have taken more far-reaching remedial action in some cases if it had the resources available to do so. Indeed, it has been suggested that the resource constraints imposed on the Bureau have resulted in an under-enforcement of the *Competition Act* (Stanbury, 1996. p.74). The implication is that the enforcement record reflects both the Director's interpretation of the statute and enforcement resource constraints. The manner in which the Director might deal with a merger among Schedule I banks may depend, in part, on the resources available to the Competition Bureau.

Merger Review Activity in General

The record of merger enforcement activity under the *Competition Act* is summarized in Table II.1 at the end of Section II. Calculations based on the last column of the Table indicate that (excluding the half year 1986), roughly 22 percent of publicly reported mergers were examined by the Competition Bureau and about 1.6 percent (7.5 percent of those examined) have raised an issue under the *Competition Act.* Enforcement methods appear to have changed over time with monitoring being utilized relatively less. While the numbers involved are too small to infer a change in practice, it also appears as if the use of pre-closing restructuring and post-closing undertakings has declined over time.[5]

Mergers in the Financial Services Sector

The amount of merger, acquisition or significant asset acquisition activity in the financial services sector between 1992, when cross pillar restrictions began to be removed, and 1996 is summarized in the Director's 1996 submission to the Department of Finance in regard to its review of financial institutions legislation. This is summarized in Table II.2 at the end of Section II.

A number of acquisitions of securities dealers by banks occurred before 1992. The Director apparently did not have competition concerns about any of these acquisitions. In his submission to the Department of Finance, the Director stated that these acquisitions did not leave the merged entity with a market share in excess of 35 percent which is the threshold at which the Director becomes concerned about the unilateral exercise of market power. Four firm concentration ratios were "substantial" particularly in the market for underwriting. As a consequence the director will have concerns about the interdependent exercise of market power in the event that any further mergers among securities dealers are proposed.

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[5] Although both appear to have declined in use, the Director has expressed satisfaction with pre-closure restructuring and dissatisfaction with post-closure divestiture undertakings as remedies for market power concerns. Problems experienced with post-closure divestitures include: failure to designate a viable business unit for divestiture; failure to divest to a competitive entity; and failure to divest in a timely fashion.

Cases Abandoned After Expression of Concern by the Director

Table II.1 indicates that between 1986 and 1995 22 merger proposals were abandoned by the parties as a result of opposition from the Director. Since discussions between the Director and parties proposing mergers are in confidence, there is little in the way of a public record of the reasons these transactions were abandoned. Many more transactions might have been discouraged as a result of an anticipated negative reaction from the Director.

One abandoned merger that was the subject of public discussion was the Ogilvie Mills/Maple Leaf Mills partnership proposed in 1990. The Director discussed his actions in this case at some length in his 1992 annual report.[6]

Ogilvie and Maple Leaf were Canada's two largest flour millers. At the time the merger was proposed, restrictions on imports of flour from the United States were in the process of being lifted pursuant to the Canada-U.S. Free Trade Agreement. The Director concluded, however, that the threat of competition from U.S mills was not sufficient to discipline the merged entity in Atlantic Canada, Quebec and the prairie provinces. He suggested either that the parties postpone the merger for six months to determine the likely extent of future competition from U.S. mills. In the alternative, he suggested that the merged entity divest its mill in Medicine Hat, Alberta and one of its mills in Montreal and also put some of the flour requirements of its bakery operations in western Canada out to tender in order to facilitate entry of new competitors. The Ontario market would be subject to monitoring by the Director with additional measures to be taken if foreign or new domestic competition did not emerge. The parties rejected the director's proposals and abandoned the merger in May, 1991.

Ogilvie and Maple Leaf Mills subsequently sold their respective flour milling operations to giant U.S. millers Archer Daniels Midland (ADM) and ConAgra. In 1997, ConAgra sold its Canadian mills to ADM. Under a Consent Order (described in the section on consent proceedings below), ADM agreed to divest one of the Montreal mills it acquired from ConAgra. Thus, ADM ended up pretty much with what the Ogilvie-Maple Leaf partnership had originally sought. In this case, however, the Director was apparently able to satisfy himself that new entrants and foreign competition would constrain the merged entity.

Pre- and Post-Closure Undertakings

A number of mergers have been altered after an initial expression of concern or opposition on the part of the Director. Campbell (1997) summarizes the information disclosed by the Director, as of March 31, 1995, with respect to the five mergers in which the Director negotiated pre-closing restructuring and the ten mergers in which the Director negotiated post-closing restructuring.

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[6] Director of Investigation and Research, Annual Report for the year ended March 31, 1992 p.7.

Pre-Closing Restructuring

In *Nestlé-Nabisco* (1987), Nestlé agreed to divest two of three coffee supply divisions it had acquired from Nabisco in order to alleviate concerns raised by the Director regarding the elimination of a vigorous and effective competitor in a market with substantial barriers to entry in western Canada. In *Nabisco/Interbake* (1987) Nabisco agreed to divest all but the snack cracker export business of Interbake as a result of concerns raised by the Director that the acquisition would otherwise lessen competition substantially in the cookie and cracker markets. The Director cited the high market share of the merged entity and the removal of a vigorous and effective competitor as sources of his concern.

In *Hostess/Frito-Lay* (1988) the Director concluded that the proposed merger (partnership) of two salted snack food companies would lessen competition substantially in that market. In response, the parties agreed to divest various assets (a plant, trucks, equipment, brand names) to a smaller competitor. In *Northern Alberta Dairy Pool (NADP)/Palm Dairy,* NADP revised its plan to acquire all the operations of Palm Dairies east of B.C. and acquired only Palm's northern Alberta operations instead. Beatrice acquired the balance of Palm's operations. The director had concluded that the acquisition as initially structured would lessen competition substantially in Alberta.

In *Shell Canada/Pay Less Gas* (1992) the Director objected to the lease arrangements and supply contract for 51 service stations in Alberta on the grounds that it would lessen competition substantially in certain local markets. The parties made unspecified alterations in their agreements and these alleviated the Director's concerns.

On the basis of the information disclosed, it is not possible to discern what the structure of the market would have been were it not for the restructuring of these mergers. Nor is there much information on the effectiveness of these changes in rectifying the problems initially identified by the Director. Campbell (1997, p.312) suggests that in one case, the remedy may have resulted in considerable interdependence between the competitors remaining in the market.

Post-Closing Undertakings

In *Safeway/Woodward* (1986), the Director concluded that the acquisition of 23 Woodward food stores by Safeway would lessen competition substantially in six cities. To alleviate the Director's concerns, Safeway agreed to divest twelve stores specified by the Director.

Trailmobile/Fruehauf (1988) involved the acquisition of the largest semi-trailer manufacturer in Canada by the second largest (Trailmobile). Trailmobile initially agreed to sell its own semi-trailer business in its entirety in order to eliminate the anticompetitive effect of the transaction. Ultimately, the Director acquiesced to the sale of the Trailmobile's brand name and designs to a Canadian competitor.

Provigo/Steinberg (1988) involved the acquisition of seven supermarkets from Steinberg by Provigo. The Director concluded that there would be a substantial lessening in two of the seven local markets as a result of the acquisition. In response, Provigo agreed to divest one store

and franchise another. Campbell (1997, p.316) notes that the Director's discussion of the case does not explain how franchising the acquired outlet would alleviate the substantial lessening of competition resulting from the acquisition.

CBR/Revelstoke (1988) involved the acquisition of 22 ready-mix concrete plants in western Canada. The Director determined that the acquisition would result in a substantial lessening of competition in two local markets. These were Grande Prairie, where there would be a local monopoly, and Red Deer where the number of competitors would be reduced from three to two. CBR agreed to sell a plant to a competitor in each of these markets.

Maclean Hunter/Selkirk involved a purchase of shares in Selkirk by Maclean Hunter. Both companies owned a number of broadcasting outlets. The Director concluded that the transaction would lessen competition substantially in the Calgary and Lethbridge broadcasting and advertising markets. Maclean Hunter agreed to divest a television station in each city and a radio station in Calgary. This remedy was made conditional on its approval by the CRTC which also has regulatory authority over mergers of broadcasters.

CAPAC/PROCAN (1988) involved the merger of two copyright collectives. The merged collective reduced the length of its membership contract from five to two years so that members could move more readily to a new collective in the event that one offering better terms and service was formed.

Laidlaw/Tricil (1989) involved the acquisition of the commercial waste business of Tricil by Laidlaw. The Director determined that the acquisition would result in a substantial lessening of competition in two local markets, Ottawa and Edmonton. The number of competitors would be reduced from three to two in each of these market. As a remedy, Laidlaw agreed to divest Tricil's commercial waste business in both markets.

In *Tree Island/Davis Wire* (1990), Tree Island, a producer of wire products, acquired Davis Wire, a competing producer of wire products, as part of a larger transaction. The Director concluded that the merger of the two largest producers of wire products in western Canada would lessen competition substantially. Tree Island agreed to divest Davis Wire in its entirety. As Campbell notes (1997, p.319), this transaction was not so much restructured as abandoned.

A&P/Steinberg (1990) involved the acquisition of 69 Ontario grocery stores from Steinberg by A&P. After examining the effect of the proposed acquisition in the relevant product market, which he defined as supermarkets (as opposed to grocery stores), and in each local geographic market, the Director concluded that there would be a substantial lessening of competition in eight local markets. In response, A&P agreed to divest 11 stores and possibly others if entry did not occur within two years. The agreed-upon divestiture did not materialize. The Director rescinded the divestiture requirement in two cases and extended the deadline in others.

Ultramar and Island Petroleum/Imperial Oil (1990) involved the acquisition from Imperial of a refinery, terminals and service stations in Nova Scotia by Ultramar and of a terminal in Newfoundland by Island Petroleum. Ultramar agreed to divest service stations and terminals in local marets in which it was already strong and to operate the refinery for seven years. In 1994,

Ultramar informed the Director that, due to an adverse change in circumstances, it would close the refinery. Island Petroleum agreed to operate the terminal in Newfoundland for ten years.

Kimberly Clark/Scott Paper (1996) resolved the Canadian competition issues posed by the 1995 worldwide acquisition of Scott Paper by Kimberly Clark.[7] The parties undertook to hold their Canadian assets separate after the closure of this transaction pending an investigation by the Director. The Director subsequently informed the parties that in his opinion the acquisition would lessen competition substantially in the consumer markets for baby wipes, facial tissue and paper napkins and in commercial markets facial tissue, paper towels and wiping products. Kimberly Clark responded to these concerns by divesting itself of its entire interest in Scott Paper Limited (the Canadian operations of Scott Paper).

These cases have a number of implications for those concerned about how merger law will cope with mergers in the financial services industry, especially mergers involving Schedule I banks. First, when he has had the option, the Director has taken action to preserve three firm competition (at least) in a market. Second, a majority of cases have involved local as opposed to regional or national geographic markets. Third, a number of cases have involved issues of product variety and non-price competition. Fourth, in several cases the merging firms were involved in multi-product distribution businesses. In order to define the relevant product market it has been necessary to determine the degree of competition between multiple line and specialized distributors. This required that the advantages of one-stop shopping be assessed. This issue has arisen in the context of the financial services industry where there is disagreement as to whether the relevant product market should be defined to include a bundle or cluster of services and, if so, what that cluster should contain.

Merger Decisions of the Competition Tribunal

Contested Proceedings

There have been two contested merger cases heard by the Competition Tribunal since 1986.[8] One is The *Director of Investigation and Research v. Hillsdown Holdings (Canada) Ltd. (Hillsdown)* which was decided in 1992.[9] The other is The *Director of Investigation and Research v. Southam Inc. et al.(Southam)* which was also decided in 1992 but was subsequently appealed to both the Federal Court of Appeal and the Supreme Court of Canada.[10] [11]

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[7] Annual Report of the Director of Investigation and Research, Competition Act, for the year ending March 31, 1997 p.17.

[8] Table II.1 lists two other contested merger cases. One is Alex Couture Inc., Sanimal Industries Inc./ Lomex Inc., Paul & Eddy Inc., a Quebec rendering industry case which was withdrawn by the Director in August 1992. See Director of Investigation and Research, Competition Act, Annual Report for the year ended March 31, 1993, Table 2. According to Bureau of Competition staff, the other case is the Director's contested application to vary the Gemini Consent Order which is referred to in the text as *Gemini II.*

[9] Canada (Director of Investigation and Research) v. Hillsdown Holdings Canada (1992) 41 C.P.R. (3d) 289

[10] Director of Investigation and Research v. Southam Inc. (1992), 43 C.P.R. (3d) 161.

[11] The author was retained by the Respondents in *Hillsdown* and by the Director in *Southam.*

Hillsdown

Hillsdown was a contested proceeding in which the Director sought an order that Hillsdown Holdings divest itself of its Orenco rendering facility at Dundas Ontario on the grounds that the acquisition of this facility substantially lessened competition in the Ontario market for rendering services. Through its subsidiary, Maple Leaf, Hillsdown already operated a rendering plant, Rothsay Rendering at Moorefield, Ontario. The Tribunal found that the acquisition of Orenco did not substantially prevent or lessen competition and declined to grant the divestiture order sought by the Director.

In its *Hillsdown* decision the Competition Tribunal found that a merger of two Ontario rendering firms was not likely to lessen competition substantially.[12] The merging firms accounted for approximately 62-63 percent of the southern Ontario non-captive red meat rendering business.[13] The next two largest firms accounted for approximately 12 percent each. Red meat rendering in Ontario had been in decline for some time largely as a consequence of increased reliance on frozen boxed beef from western Canada.

The Tribunal found that the geographic market should be defined more broadly than southern Ontario and that it should include rendering facilities within 200-250 miles of the merged entity's facilities whether they were in the United States or Canada.

The Tribunal's finding that the merger was not likely to result in a substantial lessening of competition was based on three factors: (i) the ability of U.S.-based renderers to compete in southern Ontario; (ii) the emerging excess capacity in southern Ontario itself and; (iii) the likelihood that within five years all non-captive red meat rendering in southern Ontario could be handled in one plant. The Tribunal was also influenced by the argument that a divestiture would have no effect on competition for non-captive business unless one of the merging firms built a new plant for that purpose.

The Tribunal's decision in *Hillsdown* may be most notable for its *obiter* on the interpretation of the efficiencies defence provided for mergers under Section 96 of the *Competition Act*. Section 96 requires that the Tribunal, having found a that a merger is likely to prevent or lessen competition substantially, then go on to consider the efficiency gains resulting from the merger. It directs the Tribunal not to make a prohibition, divestiture or dissolution order:

> ... if it finds that the merger or proposed merger in respect of which the application is made has brought about or is likely to bring about gains in efficiency that will be greater than, and will offset, the effects of any prevention or lessening of competition that will result or is likely to result from the merger or proposed merger and that the gains in efficiency would not likely be attained if the order were made.

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[12] This discussion follows Goldman and Bodrug (1993).

[13] Both parties agreed that the relevant product market was non-captive red meat rendering services and the Tribunal accepted this without discussion. This market definition is at least questionable in that both captive and non-captive users of rendering services sold homogeneous products (pork and beef) in direct competition with each other.

The interpretation placed on S. 96 by the Bureau of Competition is given in its *Merger Enforcement Guidelines*. According to the *Guidelines*, S. 96(1) creates a "tradeoff framework" within which efficiency gains that are likely to be brought about in Canada are balanced against the anti-competitive effects that are likely to result from the merger. If it can be established that the gains in efficiency likely to be brought about by the merger are greater than and will offset the anti-competitive effects, then no order can be issued.

The *Guidelines* define anti-competitive effects as:

> ...the part of the total loss incurred by buyers and sellers in Canada that is not merely a transfer from one party to another, but represents a loss to the economy as a whole, attributable to diversion of resources to lower valued uses. This loss is sometimes referred to as the deadweight loss to the Canadian economy. (1991, p.45)

In interpreting anti-competitive effects as the deadweight loss in consumers surplus resulting from merger-induced price increases, the *Guidelines* adopt what has become known as a Williamsonian or aggregate economic welfare approach to trade-off analysis.[14] This approach accepts any merger that increases profits by more than it reduces consumers' surplus. In the simplest terms, it may accept a merger which results in higher prices or poorer service provided it also results in sufficient efficiency (productivity) gains which could not be realized in other ways.

Although its decision did not turn on efficiencies, the Tribunal nevertheless took issue with the definition of the anti-competitive effect employed by the Director and by the Respondents. The Tribunal argued that the anti-competitive effect should include any redistribution of surplus resulting from the exercise of market power as well as the deadweight loss in surplus.

The Tribunal stated there was nothing in S. 96 to imply that "the effects of any prevention or lessening of competition" should be interpreted as the deadweight loss. The Tribunal went on to argue that the purpose of the *Competition Act*, as stated in S. 1.1, is to provide consumers with competitive prices as well as to promote the efficiency and adaptability of the Canadian economy. According to the Tribunal, there is no jurisprudence implying that S. 1.1 must be read so as to give precedence to efficiency over competitive prices for consumers.

The Tribunal acknowledged the argument that defining the anti-competitive effect to include transfers of surplus would result in the disallowance of a significant number of efficiency-enhancing mergers. It responded by suggesting that efficiency gains be given more weight where detrimental effects (transfer plus deadweight loss) are "not positively certain to follow" from a substantial lessening. The Tribunal's proposal was as follows:

> Certainly, one interpretation which is open on the basis of the wording of Section 96(1) is to weigh any alleged efficiency gains against the degree of likelihood that detrimental effects (both wealth transfers and allocative inefficiency) will arise from the substantial lessening of competition. That is, in those cases where such effects are likely but not positively certain to follow, one could give more weight to efficiency gains than where

[14]See Williamson (1968) and McFetridge (1996) for a survey of related literature.

> the reverse is true. The likely detrimental effects of a merger may on some occasions be moderate in extent, in others they may be quite extreme. It is not unreasonable to expect that a balancing of the alleged efficiency gains could be assessed by references thereto.
>
> To the extent that efficiency gains would be likely to lead to lower prices for consumers this would likely be determinative.[15]

The Tribunal's reasoning may imply it would not accept a merger that raised prices or degraded service in some domestic markets regardless of the magnitude of the efficiency gains flowing from it. This would narrow the efficiencies defence considerably relative to what would have been allowed under the MEGS. This may have serious implications for mergers among Schedule I banks. These mergers are frequently rationalized as being essential to realize the efficiencies necessary to compete with foreign banks. Arguments of this nature may be given limited weight by the Tribunal. We deal with this possibility in more detail in our discussion of efficiencies issues.

Southam

Southam was a contested proceeding in which the Director sought an order requiring Southam, the owner of the only two daily newspapers in the Vancouver area, to divest the two largest of thirteen community newspapers it had acquired as well as a real estate publication, *The Real Estate Weekly*. The Director alleged that the ownership by Southam of the daily and community newspapers substantially lessened competition in the newspaper retail advertising market and that the ownership by Southam of the dailies, the community papers and the real estate publication substantially lessened competition in the print real estate advertising market.

Starting in 1989, Southam Inc., the owner of the two daily newspapers in the Vancouver area, acquired thirteen community newspapers and a real estate advertising publication. The daily newspapers accounted for approximately 70 percent of newspaper advertising revenue in the Lower Mainland (the geographic market) with the community papers accounting for the remaining 30 percent. With the acquisition, Southam-owned community papers accounted for 40-45 percent of community paper advertising revenue. This implies that Southam-owned daily and community papers accounted for roughly 84 percent of community and daily newspaper advertising revenue after the acquisitions.[16]

In November of 1990, the Director filed an application with the Competition Tribunal for an order requiring the divestiture of the two largest community newspapers, the *Courier* and the *North Shore News* and the real estate publication, *The Real Estate Weekly*.

Insofar as the acquisition of the community newspapers was concerned, the Director argued that it would substantially prevent or lessen competition in the market for newspaper retail advertising services in the Vancouver area. Southam argued in response, that retail

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[15] Canada (Director of Investigation and Research) v. Hillsdown Holdings Canada (1992) 41 C.P.R. (3d) 343.
[16] *op.cit.* n.10, p.177.

advertisements in the daily and community papers respectively were not close substitutes and therefore that any lessening of competition between them could not be substantial.

Thus, the issue with respect to the lessening of competition resulting from the acquisition of the community papers by the dailies was whether they were in the same product market. If they were not, then the joint pricing of daily and community retail advertising by Southam could not result in a significant increase in advertising rates. If they were in the same product market, however, joint pricing of community and daily newspaper advertising by Southam could result in a significant increase in advertising rates. This would depend on whether there were other close substitutes for newspaper retail advertising.

The Product Market Definition Analysis of the Competition Tribunal in Southam

The Competition Tribunal described its approach to product market definition as follows:

> The delineation of the relevant market is a means to the end of identifying the significant market forces that constrain or are likely to constrain the merged entity. Initially it is necessary to identify the output of other firms that buyers can avail themselves of in the event that the price or other characteristics of the product offered by the merged firm are unacceptable to buyers. This is the task of delineating the product market, i.e. identifying the products that are close substitutes for that of the merged firm.
>
> ...
>
> Whether two or more goods are close substitutes can in principle be measured by the extent to which buyers would switch from one to another in response to a change in relative prices. This measurement, the cross-elasticity of demand, is rarely available. In practice it is usually necessary to draw on more indirect evidence such as the physical characteristics of the products, the uses to which the products are put, and whatever evidence there is about the behaviour of buyers that casts light on their willingness to switch from one product to another in response to changes in relative prices. The views of industry participants about what products and which firms they regard as actual and prospective competitors are another source of evidence that is sometimes available.[17]

Although the *indicia* of cross-elasticity differ somewhat, the approach to product market definition adopted by the Tribunal follows the hypothetical monopolist approach taken in the

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[17] *op.cit.* n.10, p.178.

Merger Enforcement Guidelines, the United States Department of Justice/Federal Trade Commission *Horizontal Merger Guidelines* and academic commentary.[18]

The mass of evidence with respect to product market definition could be characterized broadly as: (i) documentary evidence to the effect that Southam was concerned with its loss of advertising business to the community papers and that the daily and community papers had engaged in non-price competition in an attempt to attract advertisers from each other and; (ii) testimony from advertisers, some of whom used both the daily and community papers and some of whom had switched from the daily to the community papers. After reviewing this evidence, the Tribunal concluded that, while advertising in the community papers was the closest substitute for advertising in the dailies and the daily and community newspapers had been "striving to attract many of the same advertisers" by modifying their product offerings, advertisers would not likely shift between the two in response to small changes in their relative advertising rates. Hence they were weak substitutes:

> Thus, the evidence regarding the demand for newspaper advertising leads the tribunal to conclude that the community newspapers and the dailies are very weak substitutes: small changes in relative prices are not likely to induce a significant shift by advertisers from one type of newspaper to the other. Although community newspapers have over time succeeded in attracting business from the dailies, this has been caused more by changes in the conditions facing advertisers than by their responses to changes in price.[19]

The Tribunal also considered the question of whether the merger would reduce product modification rivalry between the dailies and the community papers. It reached three conclusions. First, the observed product modification rivalry was not evidence that the community and daily papers were in the same (product) market for advertising. Second, there was insufficient evidence as to the importance to advertisers of the product modifications. Third, there was insufficient evidence to show that the acquisitions would lessen this product rivalry substantially.[20]

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[18] The *indicia* of cross-elasticity of demand listed in §3.2.2 of the *Merger Enforcement Guidelines* are: (1) views, behaviour and identity of buyers; (2) trade views, strategies and behaviour; (3) end use; (4) physical and technical characteristics; (5) buyer switching costs; (6) price relationships and relative price levels. The *indicia* of cross-elasticity listed in § 1.11 of the *Horizontal Merger Guidelines* are: (1) evidence that buyers have shifted or have considered shifting purchases between products in response to relative changes in price or other competitive variables; (2) evidence that sellers base business decisions on the prospect of buyer substitution between products in response to relative changes in price or other competitive variables; (3) the influence of downstream competition faced by buyers in their markets; and (4) the time and cost of switching products. In his lengthy study of market definition Robert Pitofsky (1990), now Chairman of the Federal Trade Commission, suggests the following *indicia*: (1) past purchasing patterns in response to actual price changes; (2) parallel price movements; and (3) buyer and seller perceptions.

[19] *op.cit.* p.278.

[20] *ibid* pp. 270-75.

The Decision of the Federal Court of Appeal in Southam

The Director appealed the Tribunal's decision with respect to the community newspapers to the Federal Court of Appeal on the grounds that the Tribunal had erred in law by requiring "direct" (i.e. statistical or anecdotal) evidence that advertisers were responsive to small changes in the relative price of community and daily paper advertising and ignoring indirect evidence of substitutability which it had stated was also relevant.

In its August 1995 decision overturning the Tribunal, the Federal Court of Appeal reasoned as follows:

> Products can be said to be in the same market if they are close substitutes. In turn, products are close substitutes if buyers are willing to switch from one product to another in response to a relative change in price, i.e. if there is buyer price sensitivity. Direct evidence of substitutability includes both statistical evidence of buyer price sensitivity and anecdotal evidence, such as the testimony of buyers on past or hypothetical responses to price changes. However, since direct evidence may be difficult to obtain, it is also possible to measure substitutability and thereby infer price sensitivity through indirect means. Such indirect evidence focuses on certain practical indicia, such as functional interchangeability and industry views/behaviour, to show that products are close substitutes.
>
> To the extent that it is possible to adduce evidence of high demand elasticity, such evidence is virtually conclusive that two products are in the same product market. Evidence of price sensitivity can also come in anecdotal form which is a less conclusive, although still a persuasive factor tending to show that products are close substitutes. The fact that there is no direct evidence of substitutability, i.e. no statistical or anecdotal evidence of price sensitivity, does not show conclusively that products are not close substitutes.[21]

While the elasticity condition might have been better stated, the general analytical framework is correct. Direct evidence of price sensitivity hence close substitutability is sufficient but not necessary to show that two lines of business are in the same product market. Absent the requisite direct evidence, an inference of close substitutability may also be drawn from practical indicia such as those listed in the *Merger Enforcement Guidelines* or in the *Horizontal Merger Guidelines*.

Put in this way, the issue between the Director and Southam was simple. The Director contended that the Tribunal gave no weight to the indirect evidence which, taken as a whole, implied buyer price sensitivity and close substitutability. Southam contended that the Tribunal did consider the totality of the indirect evidence and found it insufficient to warrant an inference of buyer price sensitivity hence close substitutability.

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[21] Canada (Director of Investigation and Research) v. Southam Inc. (1996) 63 C.P.R. (3d)60.

The Federal Court of Appeal found that the Tribunal did ignore relevant indirect evidence of substitutability. The FCA found that, had the Tribunal given proper weight to two forms of indirect evidence, evidence on functional interchangeability and evidence on what the Court called broad competition or inter-industry competition, in conjunction with other, unspecified supporting evidence, it would have placed community and daily newspaper advertising in the same product market.

On the matter of functional interchangeability, the Tribunal had found that, although daily and community newspaper advertisements had the same content ("multiple price/product advertising"), they did not have the same purpose or end use because community newspaper advertising is more localized. The Court argued that differences in geographic reach were irrelevant to the determination of functional interchangeability:

> But the fact that the community newspapers are more local in nature does not go to the question of functional interchangeability, but to the behaviour of buyers as to preference for geographic scope. This latter subjective factor should not be mingled with the purely objective factor of functional interchangeability which focuses on use or purpose. In my view, "multiple price/product" advertising is a sufficient use or purpose to conclude, on an objective basis, that advertising in the Pacific Dailies and the community newspapers are functionally interchangeable. [22]

The Court's argument raises questions regarding the definition of functional interchangeability. One question is whether it is useful to distinguish between subjective and objective characteristics of a product, that is, whether differences in objective characteristics are less relevant to the substitutability of two products. Another question is what constitutes a subjective characteristic. The FCA regarded the information content of an advertisement as an objective characteristic while the number of people it reaches was held to be a subjective characteristic. An analogous distinction might be to find heating oil and natural gas functionally equivalent on the objective grounds that both provide heat while regarding differences in storage requirements, fuel volatility and furnace life to be subjective in that they involve consumer preferences.

Having met what it termed the necessary condition of establishing functional interchangeability, the Court then turned to what it viewed as corroborative indirect evidence in the form of the Tribunal's findings with respect to broad competition or inter-industry competition. The Tribunal had found that the community papers had attracted advertisers from the dailies and that the dailies were not only concerned about this but also had introduced some product modifications and contemplated others in order to lure these advertisers back. The Tribunal reasoned, however, that this did not imply that small price changes would induce advertisers to return to the dailies or that small price changes were what lured them away in the first place. These became known as the "one-way flow" and "superior product" arguments respectively.

The Federal Court found that the Tribunal erred in ignoring the evidence of what it had termed "broad competition." The FCA did not argue that the evidence of broad competition before the

[22] ibid.p.63.

Tribunal implies buyer price sensitivity. It stated only that the evidence of broad competition implies that there was competition "in fact:"

> The evidence of broad competitiveness is sufficient to show that there is competition in fact between the Pacific Dailies and the community newspapers. Southam's subjective concerns were reflected in actions it undertook to compete with the community newspapers such as the introduction of "Flyer Force." The Tribunal appeared to dismiss the evidence of inter-industry competition because the loss of Southam's advertisers to the community newspapers was part of a "one-way flow" and that many advertisers who had switched to the community newspapers would not switch back to the Pacific dailies in response to a price change. That "one-way flow" argument focuses on the concept of price sensitivity.
>
> Southam, at the very least, had an interest in stopping or slowing the one-way flow or even reversing it. Moreover, Southam introduced product modifications towards these ends. By focussing entirely on "one-way flow", the Tribunal ignored evidence that there was competition for both present and possibly, future advertisers. In short, there was competition in fact and the Tribunal erred in dismissing this evidence of "broad" competition.[23]

In essence, the FCA held that non-price competition (competition "in fact") together with functional interchangeability is sufficient to put the two products in the same market:

> While evidence of substitutability through functional interchangeability and inter-industry competition was adduced, the Tribunal ultimately ignored such evidence. In doing so, the Tribunal adopted an overly narrow approach to substitutability as it dismissed "broad" conceptions of interchangeability and inter-industry competition. In doing so, the Tribunal erred in focusing predominantly on price sensitivity. In this case, the similarity of use between Pacific Dailies and community newspapers, and the competitiveness which existed between them, is sufficient to place both in the same product market.[24]

The decision of the FCA may be read as implying that "objective" functional interchangeability plus product modification or other forms of non-price rivalry are sufficient imply that the respective demands for each of the products are highly sensitive to changes in the prices of the others. Another possible interpretation of the FCA decision is that close substitutability and high price sensitivity are not necessary to place two goods or services in the same relevant product market.

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[23] *ibid.*p.64.
[24] *ibid.*p.87.

The decision of the Federal Court of Appeal served to illustrate some of the problems which are encountered in attempting to infer buyer price sensitivity from indirect evidence.[25] It raised questions regarding the adequacy of existing *indicia*, whether they should be ranked or weighted and what the evidentiary standard should be.[26] Some of these questions were addressed by the Supreme Court of Canada to which the decision of the Federal Court of Appeal was appealed.[27]

The Decision of the Supreme Court of Canada in Southam

The decision of the FCA was appealed by Southam to the Supreme Court of Canada which rendered its judgement in March, 1997.[28] The Supreme Court overturned the Federal Court of Appeal thus upholding the Competition Tribunal. In its decision, the Supreme Court rejected the finding by the FCA that the Competition Tribunal had erred in law by failing to consider evidence of functional interchangeability and inter-industry competition, noting that, in fact, the bulk of the Tribunal's decision was taken up with the examination of these factors. The Court refused to address the question of whether the Tribunal had erred in law by according insufficient weight to evidence of functional interchangeability and inter-industry competition, stating that the *ex ante* specification of weights was inimical to the notion of a balancing test:

> A test would be stilted and impossible of application if it purported to assign fixed weights to certain factors as, for example, by saying that evidence of inter-industry competition should weigh 10 times as heavily in the Tribunal's deliberations as does evidence of physical similarities between the products in question. These sorts of things are not readily quantifiable. They should not be considered as matters of law but should be left initially at least to determination by the Tribunal. The most that can be said as a matter of law, is that the Tribunal should consider each factor; but according of weight to the factors should be left to the Tribunal. (¶.43)

Having concluded that the Tribunal did not err in law, the Supreme Court turned to the question of whether the Tribunal erred in applying the facts to the law (an error of mixed fact and law). The Court held that appellate courts owe deference to the business expertise of Tribunal in matters of mixed fact and law in general and that product market definition "... falls squarely within the area of the Tribunal's economic or commercial expertise."(¶.52) After an examination of the alternative standards of appellate review, the Court concluded that an unreasonableness

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[25] The problems encountered by both the Competition Tribunal and the Federal Court of Appeal in their attempts to define the relevant product market in *Southam* are typical of those encountered in other jurisdictions. After an exhaustive survey of U.S. jurisprudence, Keyte (1995) concludes that the role of cross-elasticity of demand in defining markets with significantly differentiated products must be clarified. Keyte suggests a primary focus on interchangeability of end-use if only to prevent the courts from misinterpreting a lack of cross-elasticity evidence as evidence of a low cross-elasticity and defining markets too narrowly. He would allow narrower product markets than those implied by product interchangeability if it could be established that product switching costs are such that a substantial group of consumers could not switch products in response to either price or quality changes.

[26] For a critique of earlier sets of *indicia* such as those promulgated by the United States Supreme court in *Brown Shoe*, see Werden (1992).

[27] The Competition tribunal also addressed the issues raised in the FCA's *Southam* decision at length in its *Tele-Direct* decision. See Section IX of this study.

[28] Supreme Court of Canada, Southam Inc. et. al. v. Director of Investigation and Research March 20, 1997.

standard would provide the appropriate level of deference to the Tribunal's commercial expertise. Under an unreasonableness standard, the Tribunal would be deemed by appellate courts to have erred in its application of the facts to the law only if the conclusions it reached were unreasonable. An unreasonable conclusion is one that is based on an assumption that has no basis in the evidence or is the result of contradictory reasoning.

Applying an unreasonableness test to the Tribunal's conclusions regarding functional interchangeability and inter-industry competition, the Court found that, while they might not have been correct, the conclusions reached by the Tribunal were not unreasonable. With respect to functional interchangeability, the Supreme Court rejected the FCA's contention that this factor should be preeminent on the grounds that this would be inimical to the balancing of the many factors relevant to market definition. The Supreme Court also dismissed as "unconvincing" the FCA's argument that differences in the geographic reach of community and daily papers were "subjective" and therefore irrelevant to the determination of functional interchangeability.

With respect to inter-industry competition, the Supreme Court saw the issue as being whether the Tribunal was unreasonable in concluding that documentary evidence that Southam regarded the community papers as its principal competitors was insufficient, in itself, to place the community and daily papers in the same product market. The Court concluded that, while it might have weighted this evidence more heavily than did the Tribunal, the Tribunal's conclusion was not without logical and evidentiary underpinning and therefore not unreasonable. The Court held that, having passed the unreasonableness test, the Tribunal's conclusion and its decision should stand.

Implications of the Appellate Decisions in Southam

While it upheld the Tribunal, the Supreme Court left the strong impression that the Tribunal's application of the market definition test would not have survived the higher, "correctness" standard of review:

> It is possible that if I were deciding this case *de novo*, I might not dismiss as the Tribunal so readily did what is admittedly weighty evidence of inter-industry competition. In my view, it is very revealing that Southam's own expert, an American newspaper consultant, identified the community newspapers as the source of Southam's difficulties on the Lower Mainland. To find in the face of such evidence that the daily newspapers and the community newspapers are not competitors is perhaps unusual. In that sense, the Tribunal's finding is difficult to accept. However, it is not unreasonable. The Tribunal explained that, in its view, Southam was mistaken about who its competitors were; and though I may not consider that reason compelling, I cannot say that it is not a reason for which there is a logical and evidentiary underpinning. More generally, I notice that the Tribunal seems to have been preoccupied with the definition of the relevant market. It is possible that the members may occasionally have lost sight of the ultimate inquiry which is whether the acquisition of the community newspapers by Southam substantially lessened competition. But again I cannot say that the Tribunal's approach was unreasonable. Definition of the relevant market is indeed a necessary step in the inquiry;

> and the fact that the Tribunal dwelled on it is perhaps understandable if, as seems to have been the case, the bounds of the relevant market were not clear. (¶.79)

The Supreme Court was as troubled as the Federal Court of Appeal by the Tribunal's apparent conclusion that "Southam was mistaken about who its competitors were." (¶.79) The inference that both appellate courts appear to have drawn and been disturbed by is that the Tribunal thought it knew better than Southam who Southam's competitors were. One interpretation is that the appellate courts would have been inclined to regard Southam's views as to whom its competitors were as decisive ("competition in fact") insofar as placing the daily and community papers in the same relevant market was concerned.

Contrary to the Supreme Court's suggestion, however, the Tribunal accepted not only that the dailies and community papers were competitors but also that each was the other's closest competitor. The question at issue was whether this was close enough. In focusing on product market definition, the Tribunal was attempting to determine whether the dailies and community papers were close enough competitors to have engaged in meaningful price competition. If the respective pricing decisions of the community and daily papers were not materially constrained by competition from the other, the merger could not result in a substantial lessening of price competition or a significant increase in prices. In concluding that Southam's documented concern over its substantial loss of business to the community papers did not, in itself, imply that the dailies and community papers were in the same product market, the Tribunal accepted the argument that advertisers formerly using the dailies had simply switched to a superior product. To the Tribunal, the shift in business that occurred was not the result of price competition between close substitutes. It does not appear to have mattered either to the Federal Court or to the Supreme Court, why advertisers left the dailies. It mattered only that, absent the acquisitions, Southam would have taken steps of some kind to recapture the business it had lost to the community papers.

Competition occurs on margins other than price. The FCA emphasized the importance of this "broad competition." The Supreme Court remarked (in the passage cited above) that in focusing on product market definition, the Tribunal appeared to have lost sight of the non-price rivalry between the daily and community papers. In contemporary terms, the competitive overlap in *Southam* may have been in the innovation market rather than the product market.[29]For further discussion and references see Federal Trade Commission (1996) Ch.7, §.B. The dailies and the community papers competed for advertisers by altering their respective products to make them more attractive to advertisers who were using or might have used the other's product. This competition may have brought them into the same product market at some point in time but it need not have done so.

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[29]The concept of an innovation market is defined in the *Antitrust Guidelines for the Licensing of Intellectual Property* as follows:

> An innovation market consists of the research and development directed to particular new or improved goods or processes, and the close substitutes for that research and development. The close substitutes are research and development efforts, technologies and goods that significantly constrain the exercise of market power with respect to the relevant research and development, for example, by limiting the ability and incentive of a hypothetical monopolist to retard the pace of research and development.

The Tribunal did, in fact, address the issue of non-price competition in its decision (pp. 270-75). It indicated that an inference that a merger would result in a substantial prevention or lessening of non-price competition would require the following types of evidence: (i) evidence that the rivalry involves modification of existing products in pursuit of a common set of end-users, (ii) evidence of past product modifications that bear significantly on consumer (end-user) choice and; (iii) evidence that the pace of product modification is likely to be reduced significantly as a result of the merger. Applying this test, the Tribunal concluded that there was insufficient evidence regarding the importance to advertisers of the product modifications undertaken by the daily and community papers. There was also insufficient evidence, in the Tribunal's view, to show that the acquisition of the community papers by Southam would prevent or lessen this product rivalry substantially.

The Tribunal neither ignored nor lost sight of the issue of "broad competition." Instead, the Tribunal concluded that there was insufficient evidence to support the inference that the acquisitions would prevent or lessen it substantially.[30] The consequences of the acquisition for non-price competition can, nevertheless, be discussed in general terms.

In general, the consequences of a reduction of competition in an innovation market depend on the perspective from which they are viewed. While a reduction in innovative rivalry hurts consumers as consumers, it may benefit society as a whole. That is, the losses experienced by consumers from a reduction in variety may be less than saving in resources formerly spent on product modification. In this case, product variety may be reduced but the value of the varieties foregone may be less than their cost. Product improvements may also come more slowly but the loss to consumers from the postponement of these improvements may be less than the cost saving from stretching out the development process.

The determination of whether a reduction in innovative rivalry is likely to be socially beneficial is an exercise in the economics of the second best. Part of the return on resources invested in innovation comes in the form of profits shifted from other innovators or potential innovators. By itself, this potential for profit shifting would result in an over-investment in innovation. But the profits of innovators are less than the social benefit of their innovations, the difference being consumers surplus. By itself, this would result in an under-investment in innovation. The two distortions (redistributive rivalry and incomplete appropriability) work in opposite directions with the net result that there could be too much, too little or the right amount of innovation. Depending on the balance of these distortions, a reduction in innovative rivalry may be socially harmful or socially beneficial at the margin.

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[30] Predicting the likely reduction in innovative rivalry resulting from a merger is problematic. Whether a reduction in product modification or other forms of innovative rivalry is substantial or not will depend on the respective capabilities of the merging firms and on the capabilities of remaining rivals and potential entrants. According to the *Antitrust Guidelines for the Licensing of Intellectual Property*, the antitrust agencies in the United States will make this assessment on the basis of either the share of relevant R&D or the share of other assets reflecting relevant innovative capability (patents, royalty income) accounted for by the merged entity and also on the basis of the assessments of customers and others in the market as to the competitive significance of the participants in the innovation market. In industries (such as newspaper publishing and banking) not characterized by large formal R&D operations or patent portfolios, measurement of the capacity for innovation both within and outside the merged entity is likely to be highly subjective and the concept of an innovation market will likely remain an elusive one.

Applied in *Southam*, this argument implies that Southam would continue to make product modifications that increase the joint profitability of its daily and community papers but expenditures that served only to increase the profits of the dailies at the expense of its community papers and *vice versa* would cease. The acquisition eliminates one distortion (redistributive rivalry) at least in part, but leaves the other (incomplete appropriability of the social benefits of innovation). As a consequence, there could be too little product rivalry and thus too little product improvement relative to the ideal.

Consent Orders

In 1989-90, the Competition Tribunal heard and granted three applications for Consent Orders under SS.92 and 105 of the *Competition Act.*[31] These are *Director of Investigation and Research v. Air Canada* (1990) (*Gemini I*), *Director of Investigation and Research v. Imperial Oil Limited* (1990) (*Imperial Oil*), and *Director of Investigation and Research v. Asea Brown Boveri Inc.* (1990) (*ABB*) .[32] [33] No further Consent Orders were sought until 1997 when the Tribunal heard and granted three more applications. These are *Director of Investigation and Research v. Dennis Washington et.al.* (1997) (*Seaspan*), *Director of Investigation and Research v. Canadian Waste Services Inc.* (1997) (*CWS)* and *Director of Investigation and Research v. ADM Agri-Industries* (1997) (*ADM*).[34]

The Tribunal has also heard an application by the Director under S. 106 of the *Competition Act* to amend an earlier Consent Order (*Gemini I*). In this case, *Director of Investigation and Research v. Air Canada (Gemini II)*, decided in 1993, the Tribunal discussed the likely effect of the bankruptcy of Canadian Airlines International on competition in the air passenger transportation market in Canada at length.[35]

In *Imperial Oil*, the Director sought a Consent Order to remedy what, in his view, were the anti-competitive effects of the merger of two of Canada's larger vertically integrated petroleum companies, Imperial Oil and Texaco Canada. On the basis of product flows (shipments) data, the Director defined three geographic markets, the Atlantic region, Ontario and Quebec and western Canada. The merger reduced the number of refiners in the Atlantic region to two, one of which did not sell to independent marketers. The merger reduced the number of refiners in Ontario and Quebec from six to five and left the merged entity with 28 percent of refining capacity in that region. There was no change in refining capacity shares in western Canada.

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[31]The Tribunal has also rejected one consent order. The proposed order in *Palm Dairies* (1986) was rejected by the Tribunal on the grounds that it would have involved the Tribunal in on-going regulatory supervision of the merged entity. The parties subsequently abandoned the transaction rather than become involved in contested proceedings before the Tribunal.

[32]Director of Investigation and Research v. Air Canada (1990), 27 C.P.R. (3d) 476; Director of Investigation and Research v. Imperial Oil Ltd, file No. CT89/3, February 6, 1990 (unreported); Director of Investigation and Research v. Asea Brown Boveri Inc. (1990) 27 C.P.R. (3d) 65.

[33]The author was retained by the Director in *Imperial Oil* and by the Respondent in *ABB*.

[34]Director of Investigation and Research v. Dennis Washington et. al CT96/1, January 29, 1997; Director of Investigation and Research v. Canadian Waste Services Inc. CT97/1, March 5, 1997.

[35]Director of Investigation and Research v. Air Canada (1993), 49 C.P.R. (3d) 7.

The Director viewed the merger as increasing the likelihood of collusive behaviour among refiners. The tendency toward interdependence was seen as flowing from the concentration of refining, the homogeneity of the product, the vertical integration of refiners and the transparency of pricing and large number of small repeat purchasers at the retail level. The existence of a substantial wholesale market in which relatively large non-integrated marketers could play one refiner off against another was seen as a means of destabilizing any attempts at cooperative behaviour among refiners. The Consent Order was structured so as to increase or at least forestall any decrease in the ability of independent marketers to behave as strategic customers in the domestic wholesale market and to arbitrage any deviations between Canadian and U.S. wholesale prices.

The Consent Order which was issued in 1990, provided for the complete divestiture of Texaco's business in the Atlantic region. This included a small refinery, terminals and service stations. The Consent Order required Imperial to supply a specified quantity of gasoline to independent marketers in Ontario and Quebec for a period of seven years and to divest terminals and service stations throughout Ontario, Quebec and the west.[36] The service station divestiture was designed so as to leave the merged entity with a maximum retail market share of between 25 and 30 percent in each local market, depending on the share of independents in the market. Local markets were defined as Kent (a petroleum market research firm) market areas where these data were available.

The specific divestiture rule was as follows:

Independents' Share	Post-Divestiture Imperial Share
20 % or more	30 % or less
15 % - 19.9 %	25 % - 29.9 %
under 15 %	25 % or less

There were additional rules applying to non-Kent market areas and to towns and villages with populations less than 10,000. For example, in communities in which there were up to three sites, Imperial was allowed to retain no more than one. Other rules were designed to ensure that independents acquired as many of the divested sites as possible.

The divestiture ultimately involved 414 service stations (67 percent to independents) and 13 terminals (5 to independents) as well as a refinery. Although there were probably a number of factors at work, there is some evidence that the rate of increase in the retail gasoline market share of independent marketers accelerated somewhat in the years immediately following the Consent Order.

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[36] Director of Investigation and Research, Competition Act, Annual Report 1989-90, p.18.

The divested refinery operated for four years in the hands of an integrated regional refiner and then closed.[37] Part of the divestiture process was drawn out with some service station divestitures still pending as late as July, 1995. The delay has been attributed in part to the environmental clean-up problems associated with changes in ownership in this industry. With respect to the requirement to supply independent marketers, Imperial exceeded the amounts specified in the order at least one of the years the order was in effect.[38]

ABB involved the acquisition of the Canadian electric power transmission and distribution equipment business of Westinghouse, a U.S. multinational, by Asea Brown Boveri, a Swiss-Swedish multinational. The acquisition reduced the number of domestic manufacturers of power transformers of size 400 MVA (megavolt amperes) or greater to one and reduced the number of domestic manufacturers of transformers of size 40 to 400 MVA to two.[39]

The objective of the Consent Order in *ABB*, which was issued in 1989, was to compensate for reduced domestic competition by increasing import competition. It required ABB to obtain (from the Department of Finance) full duty remission on all imports of transformers of size 400 MVA or greater for a period of five years. It also required ABB to obtain an accelerated reduction of tariffs on imports of transformers of size 40 to 400 MVA from the United States. These tariffs were scheduled to decline to zero over a ten year period under the Canada-United States Free Trade Agreement. Under the Consent Order, they would decline to zero in three years.

The Consent Order in *ABB* also embodied what has become known as a "crown jewel" provision. If ABB failed to obtain the accelerated reduction in tariffs on imports from the United States within a specified time limit, it would be obliged to divest the smaller of the two plants it had acquired. If ABB failed to obtain the remission of duties on imports of 400 MVA transformers, it would be obliged to divest the entire transformer manufacturing business it had acquired from Westinghouse. It turned out that ABB successfully secured both accelerated tariff reduction under the FTA for 40 - 400 MVA transformers and the five year duty remission on imports of 400 MVA and above transformers from all countries. The five year duty remission was scheduled to expire at the end of 1994. On receiving representations from electrical utilities that the remission of the 15 percent duty on large transformers had enabled overseas suppliers to compete successfully in the market and that anticipated competition from U.S. sources (which have duty free access to the Canadian market) had failed to materialize, the Director asked the Department of Finance to extend the duty remission for a further five years.[40] This extension runs until 1999.

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[37]The firm acquiring the refinery, Ultramar, had undertaken to operate the refinery for seven years but was allowed to close it on 90 days notice in the event of a material adverse change in circumstances. The closure was subject to an unsuccessful legal challenge from both the labour union representing the refinery workers and the provincial government.

[38]Annual Report of the Director of Investigation and Research, Competition Act, 1991-92 p.12.

[39]Hunter (1989).

[40]Director of Investigation and Research, Competition Act, Annual Report for the year ended March 31, 1995 p.24.

Gemini I involved a merger of two airline computer reservation systems (CRS), Reservec, owned by Air Canada and Pegasus owned by Canadian Airlines International (as it was then known). The merged entity, Gemini, had approximately 80 percent of the CRS business in Canada with Sabre (owned by American Airlines) having nearly 20 percent and three other CRS vendors having insignificant market shares.

The Consent Order in *Gemini I* (issued in 1989) involved the specification of a set of operating rules for the computer reservation system (Gemini) operated by Canada's two scheduled passenger airlines, Air Canada and Canadian Airlines International. The operating rules in the Consent Order were similar to those imposed on CRS vendors in the United States in 1984 by the Civil Aeronautics Board. Gemini was to be operated so as to list competing (non-hosted) airlines in a non-discriminatory manner and was also required to provide competing reservation systems with last seat availability information for Air Canada and Canadian on a reciprocal basis. Air Canada and Canadian were also forbidden from using Gemini to coordinate fare-setting and otherwise reduce competition between them.

Insofar as competition in the CRS market was concerned, the Consent Order did have a positive effect. In its 1993 decision with regard to an application by the Director to vary the *Gemini* Consent Order (*Gemini II*, see below), the Tribunal concluded:

> Further, the evidence before the Tribunal is very clear that the Consent Order has worked well and has achieved its essential pro-competitive purposes, having provided an environment in which Sabre has been able to increase its national share of the segments booked by CRSs from about 20 percent in 1989 to over 40 percent in 1992. No complaints have been brought to the Tribunal by carriers other than Gemini's owners with respect to the way they are treated by Gemini.[41]

In 1992, Canadian sought to withdraw from Gemini partnership in order to enter an alliance with American Airlines (which operated the Sabre CRS) but was blocked by Air Canada. The Director applied to the Tribunal for an order releasing Canadian from Gemini on the grounds that, in the absence of an alliance with American, Canadian would go bankrupt leaving Air Canada with a monopoly in most city pair airline markets in Canada. In its decision (*Gemini II*), the Tribunal accepted the Director's analysis of the competitive consequences of the bankruptcy of Canadian but decided that it did not have the jurisdiction to issue an order of this nature.[42] This decision was reversed on appeal and the matter was returned to the Tribunal which ordered the Gemini partnership dissolved. Canadian's hosting functions were transferred to Sabre in 1994 and Gemini was restructured into two companies, Advantis Canada, a computer and telecommunications network company owned by IBM and Galileo which assumed Gemini's CRS business and is owned by Air Canada. The rules for CRS operation issued in connection with the Gemini consent order remain in effect.

Seaspan involved a merger of three companies (Cates, Seaspan and Norsk) providing barging and berthing (tugboat) services on the coast of British Columbia. The merger eliminated

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[41] Director of Investigation and Research v. Air Canada (1993), 49 C.P.R. (3d) 36.
[42] For more detail, see Campbell (1993) and Campbell and Hughes (1993) and (1993a).

competition in the supply of berthing services in Burrard Inlet, eliminated the most likely potential entrant into the market for berthing services at Roberts Bank and reduced the number of competitors in the supply of covered barging and chip barging services to two. According to the Director, the markets for berthing and barging services were characterized by significant regulatory and sunk cost barriers to entry.

The Consent Order provides for the divestiture by the Respondent of assets, including tugboats and barges, sufficient to equip a new competitor. In the event that this divestiture is not successful, the Respondent is obliged to sell Cates, the Burrard Inlet berthing company, as a free-standing berthing firm as well as all barging assets of Norsk.

CWS involved the acquisition of one solid waste management firm, Laidlaw, by another, Canadian Waste Management Services (CWS). The Director alleged a substantial prevention or lessening of competition in the cities of Sarnia and Brantford where the acquisition left CWS with 90 percent and 80 percent respectively of the commercial lift-on-board solid waste management business. As a result of an earlier acquisition by Laidlaw (from Waste Management International, WMI), CWS also ended up with 70 percent of the commercial lift-on-board business in Ottawa and 95 percent in the Outaouais area of Quebec. The Director alleged a substantial lessening of competition in these two areas as well. The Director found that there was no substantial lessening in the other affected areas where two strong competitors remained. According to the Director, there were significant barriers to entry into these local markets in the form of economies of route density and staggered, long-term contracts.

The Consent Order provides for the divestiture by CWS of Laidlaw's entire solid waste management business in Sarnia and Brantford and of the WMI solid waste management business previously acquired by Laidlaw in Ottawa and the Outaouais. The Order also provides for access, on specified terms, to CWS-controlled disposal sites in Sarnia and Ottawa by the firms acquiring the businesses divested by CWS in those cities.

ADM (1997) involved the purchase by Archer Daniels Midland (ADM) of Maple Leaf Mills' (MLM) flour milling assets throughout Canada, and involves direct overlap of business between ADM and MLM in the production, marketing and sales of wheat flour. The Director identified the relevant product market as hard wheat bakery flour supplied in bulk format, and identified three relevant geographic markets: the Provinces of British Columbia, Alberta, Saskatchewan and Manitoba (the "Western Canada market"), the Province of Ontario combined with the Greater Buffalo area in New York State (the "Ontario/Buffalo market"), and the Quebec/Atlantic Canada market. The Director concluded that the transaction did not and was not likely to substantially prevent or lessen competition in the supply of bulk hard wheat bakery flour in the Western Canada and Ontario/Buffalo markets.

With respect to the Western Canada market, the Director concluded that ADM would account for approximately 48 percent of the bulk hard wheat bakery flour market, based on milling capacity, after the merger. However, there were 7 other hard wheat flour millers in this market, including Robin Hood, the second largest miller in Western Canada, which are in a position to constrain any price increase by ADM post-merger. The Director's finding was also based in part on the

planned expansion of two non-ADM mills located in Western Canada, as well as potential competition from U.S.-based mills.

With respect to the Ontario/Buffalo market, the Director found that the post-merger market share of ADM in this market would be approximately 42 percent. There were six other hard wheat millers operating in Ontario capable of serving this market, including Robin Hood which operates the second largest mill in Ontario. The Director's conclusion that there would be no substantial lessening of competition in this market was also based on the fact that the U.S. Milling Company, a flour mill located in Buffalo, New York, would be able to constrain any significant and non-transitory price increase by ADM post-merger.

The Director concluded that the proposed merger would likely prevent or lessen competition substantially in the supply of bulk hard wheat bakery flour in the Quebec/Atlantic Canada market. According to the Director, ADM's post-merger market share exceeded 60 percent, a very high market share in a highly concentrated market. The post-merger four-firm concentration ratio in bulk hard wheat bakery flour for the Quebec/Atlantic Canada market would remain at 100 percent, and the post-merger Herfindahl-Hirschman Index ("HHI") would be 4659.34, as compared to a pre-merger HHI of 2842.15.

The Consent Order approved by the Tribunal required the divestiture of a flour mill accounting for 7 percent of capacity in the relevant market as well as an agreement by ADM to supply the purchasers of this mill with additional flour on specified terms and in amounts up to 8 percent of capacity in the relevant market.[43]

Stayed Proceedings

In December 1996, the Director applied to the Tribunal for an order requiring the dissolution of the merger between Canada Maritime Ltd. and CAST North America on the grounds that this merger would significantly lessen competition in the supply of containerized shipping services between the port of Montreal and northern Europe. The Director alleged that the merged entity would have 63 percent of the market. Moreover, the merger would bring CAST into the consortium of which Canada Maritime was already a member, thus raising the percentage of the market accounted for by the consortium from 45 to 85 percent. The Director further alleged that there was no effective inter-port competition and that there were sunk cost barriers to entry into the provision of container service out of Montreal due to the requirement that the vessels used be smaller and ice-strengthened. The Director's application was notable in that the National Transportation Agency had already given regulatory approval to the merger, ruling that it was not contrary to the public interest.

In September 1997, the Director applied for a stay of proceedings when a significant new competitor did in fact enter the market. The likelihood is that the Director will ultimately withdraw his application.

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[43] Director of Investigation and Research v. ADM Agri-Industries. CT97/2, May 8, 1997.

Observations on the Merger Review Process

The *Competition Act* requires that a number of factors be taken into account when deciding whether a merger is likely to lessen or prevent competition substantially. The *Act* further precludes a the determination of a substantial prevention or lessening on the basis of market share or concentration evidence alone. Thus, a merger can not be deemed anticompetitive in Canada on the basis of concentration ratios or HHI's alone.

It has been observed that the market share threshold at which mergers are likely to be challenged is much higher in Canada is much higher than in the United States (Kennish and Fong, 1995). It is apparent that, with the exception of *Imperial Oil*, the cases considered by the Tribunal have involved mergers which created dominant firms capable of exercising market power unilaterally. Although it is contemplated in the *Merger Enforcement Guidelines*, the argument that a merger will increase the probability of the joint exercise of market power in an oligopolistic (small numbers) industry has been used only infrequently. In this, Canada may ultimately be closer to the European Community approach which is to challenge only those mergers leading to the creation or entrenchment of dominance than to the U.S. approach which is concerned with increased interdependence as well as dominance. Of course, it is also important to recognize that the Director is frequently dealing with mergers in markets that are already concentrated by U.S. standards and that his acquiescence in other mergers occurring in somewhat less concentrated market circumstances may reflect resource limitations as much as antitrust standards.

In accepting high levels of domestic concentration, the Director and the Tribunal have relied on the discipline of import competition (in *ABB*, *Hillsdown* and *ADM*), the ease of fringe expansion (*Hillsdown*), impending entry or fringe expansion (*ADM*) and the facilitation of entry through judicial network access rules (*Gemini I*). *Imperial Oil* stands out as an exception, involving the possibility of increased interdependence rather than dominance and divestitures designed to achieve specific *pro forma* merged entity market share targets of as low as 25 percent.

While a number of the cases dealt with by the Director by means of undertakings and by the Tribunal on consent involve the acceptance of relatively high levels of domestic producer concentration, the record reveals a number of instances in which the Director has acted to prevent the number of major competitors in a market from declining from three to two. In cases where the Director has acquiesced in a merger to dominance, he appears to have attached considerable importance to remedies which reduce the merged entity's *pro forma* market share to under 50 percent. When he is concerned about interdependence and has remedies available, the Director can be much more aggressive in terms of the post-merger market structure he is willing to accept. In *Imperial Oil,* the consent order imposed a 25 percent ceiling on the merged entity's share of major retail markets in which independents were relatively weak. This is probably the relevant precedent insofar as mergers among Schedule I banks are concerned.

The decisions of the Tribunal have been conditioned, but not directly influenced, by industrial policy considerations. That is, while the Tribunal's analyses of the competitive consequences of mergers have taken existing industrial policies, such as the restrictions on foreign ownership of domestic airlines and restrictions on cabotage (*Gemini II)* into account, the Tribunal has not pursued industrial policy goals beyond the protection of the competitive process. It has adhered

to this approach despite interventions by provincial Attorneys General advocating that remedies be structured so as to maintain local employment (*Gemini I*, *Imperial Oil*). The same is true of the Director who has not been responsive to arguments to the effect that "a strong Canadian player" is needed in the market. It is clear that if the ownership of Schedule I banks, bank employment and portfolio composition are important, these issues will have to be dealt with outside of the *Competition Act*.

Experience with remedial measures has been mixed. Monitoring has apparently not revealed anything that has led the Director to change his decision not to challenge a transaction. This is mildly surprising in that one might think that there would be at least one case in which the anti-competitive effects which the Director feared but was not certain of did in fact materialize. Whether monitoring has been or even could be meaningful given that the eggs are thoroughly scrambled after a merger remains an open question. Divestitures have apparently been effective in some cases (*Safeway/Woodwards*) and problematic in others (*A&P*). The divestiture remedy has taken a long time to take effect in some cases (*Imperial Oil*, due to environmental regulatory problems and *Southam*, due to appeals on the merits and on the remedy). Orders guaranteeing access or requiring supply of essential inputs have apparently been more successful. The nature and effectiveness of remedies that might be adopted in order to forestall any substantial lessening of competition resulting from a merger of Schedule I banks remains uncertain.

Suggested Procedural Reforms: Competition Bureau

The timeliness of the merger review process has been the subject of considerable comment. The duration of merger investigations within the Bureau is seen as uncertain and potentially lengthy. The Bureau has recently undertaken to guarantee "maximum turn-around times." These are: (a) 14 days for non-complex transactions; (b) 10 weeks for complex transactions; and (c) 5 months for very complex transactions.

The other major problem with merger review within the Bureau is that the basis for the Director's disposition of cases is seen as being difficult to discern. Campbell (1997, p.471) summarizes the problem in this regard as being one of the exercise of uncontrolled discretion by the Director.

The discretion of the Director may be constrained by private enforcement. This is a contentious issue that has had much discussion. One weakness of private enforcement is that the parties with the most to gain from it are aggrieved competitors. They constitute a concentrated interest group with an interest in blocking either the emergence of a more powerful competitor or aggressive competition in general and with an ability, frequently not shared by consumers, to overcome free-rider problems.

Despite the potential for the use of private enforcement as a form of competitive harassment, Roach and Trebilcock (1997) argue that there remains a "compelling case" for private enforcement of the reviewable practice provisions of the *Competition Act* primarily as a means of securing "corrective justice" but also as a means of ensuring accountability on the part of the Director. These authors suggest that anticompetitive use of private actions could be discouraged

by providing for a mandatory summary judgement procedure and a loser-pay cost rule as well as by denying private plaintiffs standing to seek interim relief.

Absent private enforcement, Campbell suggests greater transparency as a means of constraining the Director's discretion. This requires a more detailed disclosure of the reasons underlying the Director's disposition of cases. This, in turn, may require the disclosure of what has hitherto been regarded as confidential data on the markets in which the merged entity operates.

Suggested Procedural Reforms: Competition Tribunal

Insofar as the Competition Tribunal is concerned, Campbell (1997) characterizes Tribunal proceedings as long, formal (highly judicialized) and costly. As a consequence, it has been avoided, wherever possible by the Director and the parties and its caseload has been "sparse and irregular." In essence, the Tribunal as a whole, and the expertise of its lay members in particular, has been under-utilized. Campbell has suggested a number of changes which could simplify and expedite proceedings with respect to both mergers and other reviewable practices before the Tribunal as well as increasing the extent to which they rely on economic reasoning. Campbell (1997, p.499) suggests reducing the role played by Federal Court judges on the Tribunal if not eliminating them completely. He also suggests numerous ways in which case management could be improved. These include specification by the Tribunal of the key issues it wants the parties to address, the imposition of strict terms and conditions on interventions, abandonment of the discovery process, pre-filing of non-expert evidence, narrowing the grounds for appeal and confining the review of consent orders to the identification of aspects in which they are materially deficient.[44]

Insofar as jurisprudence is concerned, the two contested merger cases have been somewhat idiosyncratic – not the kind of cases that would be expected to have much in the way of precedential value.[45] Even so, some legal scholars are of the opinion that the Tribunal has shied away from the limited opportunities provided by these cases to make law. Campbell (1997, p.421) concludes that the Tribunal's decisions contain "surprisingly little exposition of legal or economic principles." He suggests that the Tribunal pay greater attention to its own past decisions, address rather than ignore the *Merger Enforcement Guidelines* and make greater use of *obiter dicta*.

Implications for Merger Review in the Financial Services Sector

Decisions of the Director and the Tribunal provide some guidance with respect to some of the merger policy issues confronting the Task Force. It has been suggested, for example, that merger assessment is ill-equipped to deal with non-price competition or, at least, has not paid proper

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[44]Particularly welcome is Campbell's suggestion that the arcane distinction between matters of fact, matters of law and mixed matters of fact and law be eliminated with respect to both matters to be decided solely by judicial members and grounds for appeal.

[45]In the abuse of dominance cases it has decided, the Tribunal has developed a body of jurisprudence relating to geographic and product market definition and barriers to entry that is applicable in merger cases. See Section IX.

attention to it. The decisions of the Tribunal and the appellate courts in *Southam* (discussed in detail above) demonstrates that the issues involved have been aired at length and that the Tribunal has a sensible framework within which to address them in the future. This does not imply that the prediction of the likely effects of changes in market structure on various non-price dimensions of competition will not continue to pose a challenge or that the financial sector does not have some unique forms of non-price competition. This issue is discussed further elsewhere in this study.

It has also been suggested that the merger review process may not take proper account of changes in barriers to entry.[46] The Tribunal's approach to the issue of barriers to entry, as expressed in *Southam* as well as other decisions, emphasizes the indivisible, specialized investment required for entry as being essential for a non-regulatory barrier to entry to exist. This is consistent with contemporary economic thinking. Those raising the issue of entry barriers may be concerned that barriers to entry have been or will soon be reduced. For example, with developments in electronic banking, large scale entry into retail banking may not require the construction of a branch network or the slow development of a local reputation for soundness. As a consequence, entry barriers may be declining. Arguments to the effect that barriers to entry have recently declined or will soon decline are common in merger review. Both the Director and the Tribunal are capable of understanding such arguments and have shown a willingness to entertain them.

Some indication about the manner in which a merger of Schedule I banks might be dealt with by the Director and the Tribunal can be inferred from the consent order in *Imperial Oil.* Gasoline refining and distribution is a highly visible industry. The public appears convinced that it is cartelized. Indeed, some of the conditions conducive to cartelization listed in the *Merger Enforcement Guidelines* are present. Refining is concentrated, refiners are integrated into retailing. Retail pricing is transparent and retail purchases are small, repetitive and regular. Retail markets are local. Suppliers include integrated refiner-marketers and non-integrated independents. In *Imperial Oil,* the Director insisted that the merged entity's pro forma retail market shares be under 30 percent in all major markets and as low as 25 percent where independents were weak. There was no apparent economic calculation behind this market share ceiling. The Director also insisted that the merged entity supply product to independents (in Ontario). The Tribunal was critical of the Director for not having gone far enough to remedy the lessening of competition he had identified.

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[46]In its submission to the Task Force, the Canadian Bankers Association expressed concern that the Merger Enforcement Guidelines may not be sufficiently flexible to deal with a situation in which the extension of operations from one geographic area to another becomes easier:

> The CBA has one concern about the merger guidelines, related to the fact that theyoutline the need to define the "market" as a critical element of competition policy analysis.
>
> Two kinds of markets are assessed: a geographic market and a product market. Nevertheless, in the financial services sector, technology is dramatically redefining the concept of market from both perspectives. We are concerned that the existing merger guidelines may not be flexible enough to accommodate this redefinition. New technology is moving us further towards a truly national market for financial services. In fact, Wells Fargo Bank's market entry shows that even small- and medium-sized businesses (SMEs) are not restricted to local service providers. (1997, p.90)

This scenario has some obvious similarities between Imperial Oil and mergers among the six largest banks. It is not inconceivable that the Director could seek a similar remedy, that is, to require divestitures in local markets to keep the market share of the merged entity in any significant product line below, say, 25 percent. This ceiling might depend on the importance of non-Schedule I bank suppliers of the major product lines in the local market.[47] A supply guarantee to non-integrated competitors (i.e. financial service firms that borrow from the banks but also compete with them) might also be required. Of course, there are also differences in the two scenarios. Import competition was important in some gasoline markets. There are many more product markets to deal with in the financial services industry. The technology is changing faster. Divestiture remedies may be more difficult to effect.

Mergers among Schedule I banks are frequently said to be efficiency-driven. While we discuss this issue at greater length elsewhere in our report, we note here that the Director interprets Section 96(2) narrowly and consequently would probably not credit a merger *directly* for increasing foreign sales or forestalling the loss of them. The Tribunal's interpretation of Section 96 is narrower yet. According to its view, any merger resulting in higher prices or poorer service to domestic customers fails regardless of the magnitude of the efficiency gains and additional exports flowing from it.

More generally, it is apparent that, in a number of respects, the merger review process in general has not proceeded as was anticipated. Insofar as the Director's role is concerned, there appears to have been some movement toward a more expeditious and transparent process. Some of the reforms suggested for the Tribunal would require legislation and recent proposals to amend the Competition Act do not address them. There is no reason why suggested reforms of a more operational nature cannot be undertaken.

To say that the process is slow and that the jurisprudence isn't what one would have expected after eleven years is not to say that there are better alternatives for dealing with mergers involving financial service firms in general and Schedule I banks in particular. While other regulatory processes in Canada and elsewhere may have attractive features which are worthy of incorporation into proceedings under the Competition Act, it is difficult to find any regulatory regime that is not flawed in some respects.

Although the received body of legal concepts, principles and rules is perhaps not what it might be, it is all the merger review process, whether located in the Competition Bureau or the Department of Finance or elsewhere, has to work with. Moreover, in the event that mergers among Schedule I banks are proposed, there are likely to be relatively few of them. They will dominate the merger review process for a relatively brief period of time but the procedural failings of that process will not pose an ongoing issue. This is not likely to be true of the abuse of dominance and vertical restrictions sections of the Act. This receives further attention in Section VIII and IX.

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[47] This begs the question of whether there can be any economic logic underlying such market share ceilings and, if there can, whether the ceiling should be different in branch banking than it is in gasoline retailing.

Table II.1
Merger Enforcement Activity Under the Competition Act 1986-96

Fiscal Year	86-87	87-88	88-89	89-90	90-91	91-92	92-93	93-94	94-95	95-96	Total
Examinations Commenced	40	146	191	219	193	195	204	192	193	228	1,573
Examinations Concluded:											
As Posing No Issue Under the Act	17	120	166	204	170	196	198	185	183	204	1,643
With Monitoring Only	5	7	10	13	10	5	4	1	2	4	61
With Pre-closing Restructuring	-	2	1	-	-	-	-	-	-	-	3
With Post-closing Restructuring/Undertakings	1	2	3	1	2	-	-	-	-	-	9
With Consent Orders	-	-	-	3		-	-	-	-	-	3
Through Contested Proceedings		-	-	-	-	1	2	-	1	-	4
Abandoned by Parties as a Result of Concerns of the Director	3	2	2	2	1	1	3	2	3	3	22
Publicly reported mergers	938	1,082	1,053	1,091	944	739	627	600	-	-	7,074
Mergers Posing an Issue/Publicly Reported Mergers	0.025	0.024	0.024	0.014	0.024	0	0	0.012	-	-	0.016

Note: Mergers are for the calendar year. Mergers for years 1994 - 1996 not available.

Source: Annual Reports, Director of Investigation and Research, Competition Act.

Table II.2
Mergers and Acquisitions in the Financial Services Sector 1992-96

	Target				
Acquirer	**Banks**	**Trust & Mortgage Companies**	**Life & Health Insurance**	**Property & Casualty Insurance**	**Securities Dealers**
Banks	9	11	3	1	3
Trust & Mortgage Companies	-	4	-	-	2
Life & Health Insurance Companies	1	1	13	-	-
Property & Casualty Insurance	-	-	-	7	-
Securities Dealers	-	-	-	-	-

Source: Director of Investigation and Research (1996)

III. The Views of the Competition Bureau on Competition in the Financial Services Industry

Bank Mergers

According to its submission to the Task Force (Canada, Director of Investigation and Research, 1997), the Competition Bureau intends to apply its *Merger Enforcement Guidelines* (MEGS), without serious modification, to bank mergers.[48] Specifically, the Bureau intends to use the same tests and standards for geographic and product market definition (hypothetical monopolist test using a 5 percent price increase for one year), the same market share and concentration safe harbours (a merger is unlikely to be challenged if: (1) the merged entity's *pro forma* market share is less than 10 percent or; (2) the merged entity has less than 35 percent of the market *and* the four firm concentration ratio is less than 65 percent) and the same standard for determining ease of entry (ability of the merged entity to sustain a 5 percent price increase over two years).[49]

The Bureau does not follow the DOJ and FRB in choosing different thresholds at which a bank merger is no longer assured of a safe harbour. The more generous safe harbours for banking mergers in the United States are intended to compensate for the fact that market size is measured in terms of bank deposits and some thrift deposits and, to the extent that other depository institutions and other suppliers of financial services are excluded, market size is understated and the market shares of the merging banks are overstated. The FRB goes further still, defining yet higher thresholds below which mitigating factors (such as low entry barriers) are likely to apply. The Bureau, in contrast, has chosen to stick with the thresholds that are in the MEGS. This may be taken to imply that the Bureau intends to include the revenues of all providers of relevant financial services when it measures the size of the market. This is not easy to do. It should also be noted that the concept of a safe harbour carries more weight in the United States than in Canada. In Canada, many mergers falling well outside the safe harbours in the MEGS have not been the subject of undertakings or consent orders let alone challenges.

Market Definition and Screening

With respect to market definition, the Bureau concludes that product markets are likely to be defined for individual financial services (i.e. loans of a certain type and size) and for individual groups of customers (small business, customers seeking one stop shopping). The Bureau will not follow the Federal Reserve Board approach in assuming that the product market is banking services in aggregate (cluster market). The Bureau also concludes that the markets for at least some financial services are likely to be local. The implication is that there could be a large

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[48]The Competition Bureau subsequently asked for public comment on its proposed approach to the assessment of Schedule I bank mergers. This raises the possibility that the approach described in its submission to the Task Force may ultimately be modified.

[49]This defines the safe harbour. Put another way, the *Guidelines* state that the Director will have competition concerns arising from possible interdependent behaviour when the merged entity has more than 10 percent of the market and the four firm concentration ratio exceeds 65 percent. He will have competition concerns arising from the unilateral exercise of market power when the market share of the merged entity exceeds 35 percent.

number of customer/product/geographic markets in which a merger may pose competition problems. In order to simplify the process of determining the markets, if any, in which a proposed merger may pose competition problems, the Bureau has proposed a screening process. In this regard it has departed somewhat from the MEGS.

One possible screening process begins with a basic geographic area known as a Census Subdivision (CSD). A Census Subdivision often coincides with a city, township or a rural municipality.[50] Statistics Canada aggregates Census Subdivisions into Census Metropolitan Areas (CMA's) and Census Agglomerations (CA's). A CMA is an urban core with at least 100,000 in population together with adjacent urban and rural fringe areas that have a high degree of social and economic integration with the urban core. A CA is an urban core of at least 10,000 in population together with adjacent urban and rural fringe areas that have a high degree of economic and social integration with the core.

Statistics Canada has a set of rules for aggregating Census Subdivisions (CSD's) into CMA's or CA's. These rules are based on migration patterns. The *forward migration rule* states that if at least 50 percent of the employed labour force living in a CSD work in the urban core then that CSD is included in the CMA or CA. The *reverse commuting flow rule* states that if at least 25 percent of the employed labour force working in a CSD live in the urban core, then that CSD is part of the CMA or CA.

One possibility would be to define the geographic market as a CMA or CA. The banking and antitrust authorities in the United States frequently take a similar approach, using Metropolitan Statistical Areas (MSA's) and Rand McNally Areas (RMA's) as geographic markets. Under this approach, the geographic market would include the urban core plus any CSD in which either 50 percent of the resident employed labour force worked in the core *or* 25 percent of the employed labour force resided in the core. The Bureau apparently does not intend to take this approach. Instead, it proposes to begin with CSD's. It will find all the CSD's in which the proposed merger would exceed the market share and market concentration thresholds with respect to some line of business or aggregation of lines of business. Presumably, an aggregate measure of production of financial services is the place to start. If there is a problem at the aggregate level there must also be a problem with respect to one or more individual lines of business. A simple place to start would be with the number of branches. Another would be deposits. What the Bureau would then do would be to find all the CSD's in the country in which the market share or market concentration threshold, measured in terms of the number of branches or value of deposits, of (presumably) all deposit-taking institutions is exceeded. Again, it is difficult to believe that the Bureau will apply the 65 percent-10 percent interdependence threshold strictly in this screening process but it has not indicated otherwise.[51]

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[50] In Ontario, for example, there are 947 Census Subdivisions of which, 51 are cities, 140 are Indian Reserves, 147 are towns, 468 are townships and 108 are villages.

[51] The FRB threshold with the usually present mitigating factors is a 250 point change in the HHI to a post-merger HHI of 2200. The FRB would ordinarily have no competition problem when the merging banks have a combined market share under 23 percent. [Δ HHI = $2s_1s_2$, so that any pair of market shares with a product less than 125, say 10 percent and 12.5 percent, would not exceed the threshold].

Having found the CD's in which the threshold is exceeded for some aggregate measure of financial services production, the Bureau would then ask whether there is a case for aggregating any of these CD's with adjacent CD's into a larger geographic market. The case would be made on the basis of commuting data which is available from the census. Whether the Bureau will use a different rule to aggregate CD's than Statistics Canada does is not clear. If it uses the same rules, it may as well start with the CMA's or CA's that Statistics Canada uses. Whether aggregation rules should differ depending on the product market involved and, if so, whether this would be practical, is an interesting question. The case for combining adjacent CD's into larger geographic markets depends on the proportion of the respective populations in each CD employed in the other and the likelihood that commuters would switch from a bank near their residence to a bank near their place of employment or vice versa.

Having applied their CD aggregation rule, whatever it may be, the Bureau would then determine whether any of the CD's in which the market concentration and market share threshold is exceeded can be combined with CD's in which the threshold is not exceeded. The Bureau's submission appears to imply that the ability to combine a CD in which the threshold is exceeded with a CD in which it is not, is sufficient to eliminate potential competition concerns. Another approach would be to determine whether the threshold is exceeded in the combined CD's. The problem with this approach is that it implies a remedy applied, at least partly, to a geographic area in which there was no problem initially. It is quite conceivable, for example, that Ottawa may be in the relevant market for a bank merger in Arnprior while Arnprior is not in the market for a bank merger in Ottawa.

The result of applying this method should be to reveal some CD's in which the market share and concentration threshold is exceeded and which cannot be combined with other CD's in which the threshold is not exceeded. These would be the CD's to which further analysis would be devoted.

Recall, however, that this test was applied using branch numbers or deposits or a similar indicator of production of financial services. Exceeding the threshold so measured is sufficient to imply that further analysis is required but it is not necessary. The threshold may still be exceeded for a particular line of business even though it is not exceeded in aggregate. The question then becomes whether this particular line of business is a relevant product market.

For example, the merged entity may have 30 percent of the deposits in the geographic market but supply 40 percent of the mortgages. The (unilateral market power) threshold would not be exceeded for deposits but would be exceeded for mortgage loans. The question is whether mortgage lending is a relevant market. This is a question that should be addressed before the geographic market screening exercise is undertaken. Otherwise, problem geographic areas may be identified for lines of business which are not product markets. The threshold may not be exceeded for the appropriately defined product market.

The Bureau has taken the view that while money may be fungible, it comes bundled with expertise which may be costly to replicate. Consumer lenders may not be able to switch costlessly to mortgage lending either because they do not have the requisite expertise or reputation or because funds are not infinitely elastic in supply. It may, therefore, not be correct to assume that the relevant product market can be defined as broadly as "lending" or

"deposit-taking." The implication is that different firms may be included in the market for each line of business. Specialized consumer lenders would be included in the market for consumer loans, specialized mortgage lenders would be included in the market for mortgage loans etc. If data on the value of services provided by the relevant nonbank specialists do not exist or are not complete, the thresholds will have to be revised upwards FRB style and also to vary from product line to product line.

The Bureau has already adopted line of business definitions for relevant product markets in the securities dealers industry.[52] These are: (a) the consumer or retail market; (b) the institutional equity market; (c) the institutional debt market; (d) the underwriting market; and (e) the acquisitions market. This isn't to suggest that the Bureau might not also layer a multi-product securities dealers market on top of these individual product markets. The Bureau has also defined a number of product markets within the group life and health insurance business.[53] These include: (a) group life insurance; (b) accidental death and dismemberment insurance; (c) medical and dental insurance; and short-term and long-term disability insurance. These products may also be sold in packages and the Bureau may also regard packaged sales as a relevant product market. The individual life insurance business is also regarded as a relevant product market. The Bureau views the latter market as local. The Bureau has also indicated that it would define automobile insurance as a product market and the geographic market as local.[54]

Concentration Thresholds

The Task Force has asked whether the concentration thresholds in the MEGS are appropriate for bank mergers. The Bureau's submission implies that it will apply the same thresholds to financial sector mergers as it applies everywhere else. The FRB and the DOJ have more generous thresholds but this simply reflects a recognition that they have understated the size of the market. They do not in any place imply that the nature of the financial services industry is such that, given correct measurement of the size of the market, different thresholds would be required. That is, there is nothing in DOJ or FRB practice to indicate that, other factors (barriers to entry, availability of substitutes, etc.) being equal, the threshold at which unilateral market power can be exercised or at which collusive action becomes possible is different in financial services industry than in other industries. Of course, this may or may not be the correct view and arguments that the financial services industry is more or less amenable to cartelization must be examined.

It is also important to recognize that guidelines are just that. They are not binding. Enforcement agencies may do things somewhat differently than they say they do. The effective enforcement thresholds during the first twelve years of administration of the *Competition Act* appear to have been higher than is stated in the MEGS. Similarly, there are many banking markets in the United States that are already highly concentrated. Mergers may have been allowed in some of these

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[52] Submission of the Director of Investigation to the Department of Finance (1996), ¶.89.
[53] Submission of the Director of Investigation to the Department of Finance (1996), ¶.90.
[54] Submission of the Director of Investigation to the Department of Finance (1996), ¶.91.

markets In Australia, both the ACCC and the Wallis Commission have expressed views on the number of banks (and especially on the role of regional banks) they think are necessary.

There may also be some guidance from economic theory. Market models may imply some rules. They can also be used to simulate the effects of mergers. These issues are discussed in Section VI which deals with market power. Of course these models are crude. In particular, they don't deal well, if at all, with potential entry, spatial competition or the effects of technological change.

Issues Not Addressed

There are a number of issues that the Bureau's submission did not address. One issue is what price will be used in applying the hypothetical monopolist test in the market definition and barriers to entry exercise. What price does the hypothetical monopolist increase by 5 percent? Are we talking about a 30 basis point increase on a 6 percent mortgage rate? This issue promises to be troublesome. Banks are intermediaries and the price they charge for intermediation services is their spread. Banks also charge fees and sell services other than intermediation. Even if banks can still reasonably be characterized as intermediaries, it may be difficult to pose the question to customers "how would you respond to a 5 percent increase in your bank's spread?"

This leads to a second issue. While the discussion in Section II above makes it clear that the Director and the Tribunal are aware of the issue of service competition, the market definition exercise and the definition of a substantial lessening of competition is cast in terms of price increases. The link between changes in market structure and quality of service is not as straightforward as the link between market structure and price. Does increased market power necessarily lead to poorer service?[55] What is the threshold degradation of service by a hypothetical monopolist? Would the response of consumers be similar or would we get different geographic and product market definitions?

A third issue is the interpretation of market shares. First, there should be an allowance for measurement error as the U.S. authorities do. Second, market shares may mean something different in terms of the intensity of competition in banking than they do in other industries. As the discussion in Sections IV and V indicates, neither the U.S. nor the Australian authorities see this as necessarily being the case. Market-specific characteristics of competition can, in any event, readily be incorporated in the determination of the likelihood of a substantial lessening of competition under Section 93. Third, local market shares may not be a very good indicator of the capacity to compete in a given local market. The question here is whether a bank with a national branch network but with 10 percent of the mortgages in a given local market should be weighted

[55] Another aspect of the service question is whether a reduction in competition would increase the probability of Type I error in granting credit. Put another way, does a reduction in competition increase the probability that a good risk will incorrectly be denied credit? While most economic models see credit rationing as a problem of asymmetric information and absence of collateral rather than one of market structure, there is a public perception that a more concentrated banking sector would be more likely to deny credit to good credit risks, especially if they are small businesses.

the same as any other competitor with 10 percent of the market. A related question is what the terms capacity and the ability to expand capacity mean in banking markets.

A fourth issue is national pricing. It is argued that the major banks set prices nationally and do not respond to local market conditions (which itself may imply something about competition). While there is evidence (see section IV) that U.S. bank holding companies accord their local managers considerable discretion, there does not appear to be any published evidence on this issue in Canada. Nor is there any evidence on the effect of local market conditions on the quality of service offered. In the absence of such evidence, it might be difficult to make a case for selective local divestitures.

A fifth issue is which efficiencies are eligible for the efficiencies defence under Section 96. This issue is discussed in detail in Section VII.

Non-Merger Issues

The Bureau's submission also deals with competition issues other than mergers as they relate to the financial services industry. Vertical restrictions and abuse of dominance are discussed in Sections VIII and IX below. Time does not permit the discussion of Canadian experience with criminal prohibitions of horizontal restrictions on competition in detail. A few brief comments must suffice.

Suspicion that the major banks act in concert appears widespread among the public. The Director's submission to the Task Force notes that, to the extent that this behaviour is the result of independently realized self-interest, it is beyond the reach of the *Competition Act*. The Director's submission further notes that this "conscious parallelism" occurs when firms act identically with respect to a key competitive variable (prices, prime rate, GIC rate) because they realize that it is their collective interest to do so. This is not an offence under S.45. For an offence under S.45, evidence is required that the accused made an agreement and that they ought to have known that the effect of their agreement would be to lessen competition. While evidence of parallel action can be used in support of an inference an agreement, the evidence must go beyond this. This is sometimes called "parallelism plus." Evidence in the form of practices designed to induce parallel behaviour or to reduce the attractiveness of price cutting (make competitors "soft") might be sufficient. These practices are known as "facilitating devices."

The Director also has S.49 at his disposal. Section 49 is a *per se* prohibition of practices such as price fixing or customer or market allocation among federally chartered financial institutions. Section 49 is stronger than Section 45 in that the lessening of competition involved does not have to be undue. S.49 could be further strengthened by eliminating the ability of the Minister of Finance to grant additional exceptions (under S.49(2)(h)) to the section at his discretion.

S.49 is unique to federally chartered financial institutions. This targeting might be justifiable if there were evidence that stronger anti-cartel measures are required in the markets in which these institutions operate than in any other market in the country. The argument would have to be that agreements in the areas not exempted under 49(2) never have redeeming virtues (like bid-rigging or so-called naked price fixing) and that the markets in which federally chartered financial

institutions operate are especially vulnerable to cartelization. This would be the case if, for example, the characteristics of these markets are such that, agreements are especially easy to reach, easy to enforce and difficult to detect. The kind of characteristics that are adduced in this regard include product homogeneity, transparency of terms of sale, stability and similarity of technology, steady demand, difficult entry and small and nonstrategic customers. Provisions must also exist for credible punishment of deviation. These are demanding requirements. A number of convicted cartels have, in fact, been abject failures insofar as sustained monopolization is concerned.

While some forms of lending, deposit-taking or other intermediating activity may be vulnerable to cartelization, it is hard to see how they could be *uniquely* vulnerable or how the consequences of cartelization of these activities could be *uniquely* unfavourable. Whatever the merits of a *per se* prohibition of certain horizontal restraints, there is no argument for confining it to the markets served by federally chartered financial institutions or, worse yet, to federally chartered financial institutions themselves.

IV. Policy Toward Bank Mergers in The United States

Introduction

Bank mergers in the United States are subject to regulation by both the Antitrust Division of the Department of Justice (DOJ) and by the relevant bank regulator. The relevant bank regulator is the Board of Governors of the Federal Reserve System (FRB) for bank holding companies and state chartered banks that are members of the Federal Reserve System. For federally chartered banks the relevant regulator is the Office of the Comptroller of the Currency (OCC). For state chartered banks that are not members of the Federal Reserve System, the relevant regulator is the Federal Deposit Insurance Corporation (FDIC). The OCC and the FDIC have apparently not denied a merger on competition grounds for ten years, while the DOJ and FRB have caused many proposed mergers to be modified although they have denied only a few.

Both the DOJ and the relevant banking regulator analyze merger proposals independently using the same antitrust criteria. In addition, mergers must comply with competition-related criteria set out in the Interstate Banking and Branching Efficiency Act of 1994. This legislation forbids any bank holding company merger which would leave the merged entity with more than 10 percent of the deposits of insured depository institutions in the United States. The Federal Reserve is also prohibited from approving any merger which would leave the merged entity with more than 30 percent of the deposits of insured depository institutions in any given state. States can raise this threshold either by legislation or by decision of the state bank examiner. States can also lower this threshold by legislation and some states have thresholds as low as 10 percent (Indick and Kini, 1995, p.108). Interstate bank (as opposed to bank holding company) mergers may still be prohibited in states that have chosen to “opt out” of the interstate branching (as opposed to interstate banking) provisions of the Interstate Banking and Branching Efficiency Act. The state of Texas has, in fact, availed itself of this opting out opportunity (Rhodes, 1997, n.14).

The DOJ and the FRB conduct their investigations independently although they use the same data. While much is made of the differences in their respective methodologies, the net effect of these differences appears to be very small. Under some circumstances, the FRB may weigh the participation of thrift institutions in the market more heavily than does the DOJ. This could lead the FRB to view the relevant market as being somewhat larger and the market shares of merging banks somewhat smaller than the DOJ. Nevertheless, virtually all merger proposals are ultimately approved by both agencies once appropriate divestitures have occurred. According to Amel (1997), the FRB has denied only two merger applications in the last four years. Both involved the acquisition of thrifts by banks and both were denied because the parties were unable or unwilling to make the appropriate divestitures.

The major difference between the competition assessments of the two agencies is in structuring remedial divestitures. The FRB is interested principally in making sure that the size of the divestiture is such that the merger conforms to its market share and market concentration guidelines (see below) and that divested branches are viable. The DOJ is more concerned with the characteristics of both the assets divested, the banks acquiring them and the customers they might serve.

The differences in the respective approaches of the DOJ and FRB to the measurement of the size of the market and to structuring divestitures are a result of the DOJ's focus on the banking needs of small business. The DOJ is of the view that small businesses, being the least mobile geographically of all the customers of commercial banks, are thus least able to protect themselves from the exercise of market power by banks. For the DOJ, small business is the customer group at risk when banks merge. Since, in the view of the DOJ, thrift institutions generally do not provide the full range of services required by small businesses, they are excluded when the DOJ makes its initial calculation of the size of the market. Similarly, the DOJ intervenes more actively in the structuring of divestitures to ensure that they serve the needs of small business customers.

The U.S. system is rule-oriented and routinized. It is designed to accommodate the large numbers of merger transactions that occur in a unit banking system. The DOJ and the banking agencies have reviewed well in excess of a thousand merger transactions a year since 1990 (Guerin-Calvert, 1996, p.290).

Mergers are analyzed on a first-come-first-served basis. There does not appear to have been much of a problem with pre-emptive mergers. This may be because of the opportunities that continue to exist for interstate (geographic market extension) mergers and for mergers within individual local markets. The number of banks in the United states could drop from its current 7,300 to six without violating the merger guidelines provided each of the remaining six banks operated in each of the 2,000 local banking markets in the U.S.

Most merger proposals come complete with proposed divestitures of branches which will be sufficient to meet the market concentration guidelines used by both the DOJ and the FRB. The demand for branches is such that remedial divestitures to competitors and potential competitors is not difficult to arrange.

There are few disputes about geographic or product market definition. All parties work from pre-defined Federal Reserve Bank geographic markets. Concern is focussed on the customers and product lines (term loans to small business) with the most narrowly defined geographic markets. Other customers are assumed to have the option of availing themselves of financial services in geographic areas where the merging banks do not operate. This assumption is warranted in the context of a unit banking system such as exists in the United States. While merging banks may have a large share of the local market, their share of the regional or national market is likely to be quite small.

As far as can be determined, the respective competition assessments of the DOJ and FRB are largely redundant. The DOJ seldom challenges a merger that the FRB has approved.[56] Both assessments have a strict competition focus. Neither agency has the objective of protecting U.S.

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[56]Guerin-Calvert (1992, pp. 670-71) cites three instances in 1990-92 in which the DOJ challenged mergers that had been approved by the FRB. In each case, the DOJ settled quickly with the respondents. In each case the settlement involved the divestiture of more business and, in one case, a more structured divestiture process than the FRB had required. Guerin-Calvert emphasizes that the differences between the DOJ and FRB are infrequent and marginal.

banks from foreign takeovers. Neither agency is charged with the task of preserving bank jobs. Nor is there a concern with competitiveness *per se*. While efficiencies arguments are entertained in the case of mergers involving banks with assets under $100 million, these efficiencies have to be realized in the relevant local markets and they cannot save a merger that results in an increase in margins or a degradation of service in those markets.

The situation in Canada would be quite different in a number of respects. Only a limited number of mergers are possible. Simple decision rules are not required. Case by case analysis would be feasible. Moreover, given that Canadian banks operate nationally, the fact that for some lines of business the geographic market is national rather than local would not necessarily reduce the magnitude of the competition problem resulting from a merger. That is, for the largest banks, national market shares may be similar to local market shares. In this case, the fact that some customers are mobile geographically may not imply that they have suffered no significant diminution of choice as a consequence of a merger.

If the "big shall not buy big" policy of the federal government were rescinded, a number of mergers might be proposed within a short period of time. Given that successive mergers leave successively fewer competitors in the market, the likelihood that a given merger will be deemed to lessen competition will be greater the later it is in the queue. This may give rise to arguments that, on fairness grounds, these mergers should be analyzed simultaneously rather than sequentially. But analyzing two or more merger proposals simultaneously involves its own set of problems. If, for example, two mergers are proposed and the state of competition in the market is such that only one can go through, the task of distinguishing between the proposed mergers the basis of their respective net economic benefits may require more accuracy of merger analysis than it is typically able to deliver. This problem would, of course, not arise if neither merger were allowed to proceed or if both were allowed to proceed either with or without divestitures.

Divestiture remedies themselves might also be more difficult to arrange in Canada than in the United States. There may not be a group of deposit taking institutions in Canada interested in buying additional branches as there has generally been the case in the United States.

Geographic Market Definition

The size of the geographic market depends on the line of business and the size of the customer involved. That is, geographic markets cannot be defined independently of product markets. The DOJ and FRB make the general distinction between wholesale banking and retail banking. Retail banking services are used by most households and small businesses. These services include transaction accounts, consumer loans and small business loans. The relevant geographic market for retail banking services is thought to be local while the relevant geographic markets for wholesale banking services are regarded as being regional or national if not international.[57]

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[57]Rhodes (1996, p.345) cites a finding that seventy-five percent of households obtained their checking accounts, savings accounts, MMDA's and CD's at financial institutions within 5-12 miles of their home or workplace. Fifty percent of small businesses obtained twelve financial services they used from financial institutions located within seven miles of them.

Evidence supporting the importance of local markets insofar as households and small businesses are concerned is reproduced in Tables IV.1 and IV.2 below. These tables show that households and small businesses in the United States rely heavily on commercial banks within 2-3 miles of their residence or place of business for a variety of financial services. Markets for wholesale banking services are characterized by large numbers competition while markets for retail banking services may be concentrated. The DOJ and FRB regard a banking merger as having the potential of posing an antitrust problem only in markets for retail banking services.

The geographic market for retail banking services is defined in principle using the hypothetical monopolist test. This test asks whether a firm that monopolized the supply of banking services within a given geographic area would find it profitable to raise the price of its services by 5 percent or more for two years or more. Such a price increase would not be profitable if enough customers were able to turn to alternate suppliers of banking services outside the geographic area in question. In this case, the geographic market as initially defined is too narrow and a broader market must be considered. This enlargement of the relevant geographic market would continue until it is sufficiently broad that a hypothetical monopolist of it would find it profitable to increase the price of its services by 5 percent or more above prevailing prices.

As a practical matter, the geographic market definition exercise attempts to determine the cost to customers of turning to suppliers in adjacent geographic areas. In the United States, heavy reliance is placed on so-called "predefined markets." The twelve Federal Reserve Banks in the United States have assigned each bank in their respective districts to a retail banking services geographic market. These markets are generally highly localized. In specifying the boundaries of these local markets, the Federal Reserve Banks rely extensively on the determination of others that a region is economically integrated. In urbanized areas, geographic markets most frequently coincide with so-called Ranally Metro Areas (RMA's). RMA's are defined around all major U.S. cities by Rand McNally, a geographic research and mapping company. RMA's contain one or more central cities, satellite communities and suburbs. They do not necessarily follow county or other legal boundaries. The Federal Reserve Banks also make use of Metropolitan Statistical Areas (MSA's) and Labor Market Areas (LMA's). MSA's are aggregations of counties. These aggregations are based on the commuting data drawn from the census. In essence, a county is included in an MSA if there is a sufficient level of commuting between it and the "core." The argument used in support of this approach is that consumers of retail banking services can bank either near their homes or near their places of business. To use a local analogy, consumers might be able to defeat a price increase by a monopolist in Ottawa by turning to banks near their homes (or placed of work) in Gloucester or Barhaven or Kanata.

In less densely populated areas where RMA's and CMA's are not defined, the Federal Reserve Banks themselves make use of commuting and other demographic data to define portions or aggregations of counties that are geographic banking markets. The issue in this case is one of defining the local trading area and determining the extent to which the respective trading areas of adjacent trading centres overlap. Trading areas are defined with respect to non-durable goods such as food, beverages and pharmaceuticals and frequently used services such as dry cleaning.

To use a local analogy, the town of Arnprior may not be a relevant geographic market both because many residents of Arnprior commute to Ottawa and could do their banking there if

prices were to increase in Arnprior and because consumers in the vicinity of Arnprior could divert their business to other trading centres such as Renfrew. The key factors to consider in determining whether this type of a diversion is likely are: (1) the lump sum cost to consumers of switching banks; (2) the cost in terms of time and transportation expense of going further afield for banking services and; (3) the ability of the banks in the alternate locations to accommodate the additional business (Bannon and Black, 1996, pp. 88-9).

In some cases, geographic market definition may not be crucial. The merging banks may be equally active throughout the entire geographic area under consideration so that it does not matter whether the geographic market is defined narrowly or broadly. That is, if banks A and B account for the same percentage of the business in both Arnprior and Ottawa, it may not matter whether Arnprior and Ottawa are treated as being in the same market or as being in different markets. In other cases it will matter. If banks A and B have 70 percent of the business in Arnprior but 35 percent in Ottawa and Arnprior taken together, geographic market definition will matter. Indeed, in the United States, the definition of the relevant geographic market would be decisive in this case. That is, if the geographic market were defined as including both Ottawa and Arnprior, the merger might pass with little further scrutiny while if Arnprior is a market, the merger would surely be blocked.

All of the agencies involved in the regulation of bank mergers in the United States use the geographic market defined as described above, in as the starting point in their respective analyses of the effects of proposed mergers on competition. Occasionally, the DOJ departs from the FRB definition. This can occur because the DOJ defines the product market somewhat differently and because, for the DOJ, geographic market definition depends on the respective locations of the merging banks. That is, the DOJ might treat two merging banks in towns 20 miles apart as being in the same geographic market but if two banks in one of the towns merged, the bank in the other town might be excluded from the geographic market.

Examples of New England retail banking markets as defined by the Federal Reserve Bank of Boston include Boston which encompasses the Boston RMA plus four towns in southern New Hampshire. The market is bounded by Cape Cod in the south. There are 18 retail banking markets in Massachusetts. Of these, three coincide with RMA's, three coincide with counties, six are RMA's plus some nearby towns and six are groupings of towns in two or more counties.

The Federal Reserve does not regard the advent of electronic banking as having broadened geographic markets for retail banking services. They maintain that relatively few households make use of computer, ATM or telephone access to *distant* banks.

Product Market Definition

There are obviously many kinds of retail banking services. The question is whether each product line constitutes a separate relevant product market. In the United States, both the enforcement agencies and the courts have rejected the argument that transactions accounts, savings accounts, commercial loans and mortgages etc. should be regarded as separate lines of business. They take the approach that the importance of a bank in the market is measured by the value of its deposits (of all kinds) and that these deposits are fungible and can thus be shifted across asset classes.

This could be called the supply-side substitutability view or the clustering view. A bank's capacity to engage in various forms of lending depends on its deposits. Conversely, a bank's deposit and other liabilities, whatever form they take, are just equal to its assets. According to this view, a bank's presence in the market is measured by the total value of its deposits rather than the value of any particular type of asset that it holds. There is evidence to support the proposition that households and small businesses in the United states rely on commercial banks for a bundle of services (see Table IV.3 at the end of Section IV). The cluster market approach makes also a virtue of necessity. Deposits are the only item reported at the individual branch level. To the extent that multi-branch banks are involved, deposits are the only available measure of local market size and of local market shares and concentration. Defining the market on the basis of deposits results in a predictable and well-understood, if possibly biased, application of the antitrust laws.

While a bank's share of various forms of lending activity in a local market may be proportional to its share of deposits, there are reasons to believe this might not be so. The evidence in the United States is that multi-branch banks do not distribute their lending activity in the same way as they distribute their deposits. This may or may not be the case in Canada. Moreover, institutions that do not take deposits may be prominent in some forms of lending activity. The cluster approach as employed in the United States excludes all nonbank financial institutions (consumer finance companies, mortgage banks, credit unions) on the grounds that they do not provide the full cluster of services supplied by banks. As a consequence, the concentration of local markets for various types of loans may be considerably overstated. The DOJ and FRB compensate for this by raising the market share threshold at which a proposed merger raises competition concerns.

Even if aggregate lending activity were closely correlated with deposits across local markets, various forms of lending activity may not be. Suppose banks A and B account for 35 percent of local deposits but account for 70 percent of local consumer loans. Banks C and D also account for 35 percent of deposits but account for 70 percent of residential mortgage loans. The assumption that deposits are the appropriate measure of market share is equivalent to assuming that if banks A and B merged and raised lending rates on consumer loans, banks C and D could shift out of residential mortgage lending and into consumer lending and thus defeat the increase in consumer loan rates. Clearly the loanable funds are fungible but this does not necessarily imply that competing institutions could make the requisite alteration in their asset portfolios in favour of consumer loans within a sufficiently short time horizon. This would depend in part on the amount of lending activity in which banks C and D engaged outside the local market. A local increase in consumer loan rates might be defeated by an infinitessimally small shift in the regional or national loan portfolios of banks C and D.

In sum, there are two questions. The first is whether a cluster, one-stop-shopping or multi-product distribution services can be a relevant product market. The U.S. evidence from 1993 at

least indicates quite strongly that it can.[58] The second question is whether the cluster market is the only relevant product market. The answer in principle is surely not. The defence for the cluster market approach in the United States is strictly one of practicality. The data for line of business analysis are not available and aggregation probably makes little difference in most cases. If the data are available and the number of mergers to be processed is small, both single product and cluster markets should be examined.

Summary of the Approaches of the DOJ and FRB to Market Definition

In urban areas, the relevant geographic market is generally a Metropolitan Statistical Area. The product market is banking services. A proxy measure of the value banking services sold in the market is deposits. For the DOJ, the size of the market, hence the denominator in its market share calculations, is expressed in terms of commercial bank deposits. For mergers increasing the commercial bank deposit HHI by more than 200 points to a level in excess of 1,800 points and thus raising potential competition concerns, the DOJ will then add the deposits of any thrift institution (savings and loan association) in the relevant geographic market that actively provides services to small business to its measure of the size of the market.

The FRB takes a different approach. It defines the size of the market in terms of commercial bank deposits plus either 50 percent or 100 percent of thrift (savings and loan association) deposits, depending on whether the thrift institutions in the relevant market engage in commercial lending.[59] Thus, in geographic markets in which the thrift institutions do not engage in small business lending, the size of the relevant market is larger (and the market shares of the merging banks smaller) under the FRB's approach than under the DOJ's approach. In rural areas the relevant geographic market is generally a county or a municipality.

Market Share and Concentration (HHI) Screens

The DOJ and the FRB follow the standard U.S. practice of inferring the likely exercise of market power post-merger from the change in market structure, specifically, the change in market concentration resulting from the merger.[60] Thus, a merger increasing market concentration beyond a certain threshold is regarded as potentially anticompetitive either because it is likely to give the merged entity the ability to increase its deposit-loan spread unilaterally or because it will increase interdependence among the banks remaining in the market and thus lead to a joint increase in deposit-loan spreads. The *Horizontal Merger Guidelines,* which apply to all industries, list further structural indicators of the likelihood of the interdependent exercise of market power. This is discussed later in this section.

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[58]While households and small businesses in the United States tend to rely on banks for a number of services, Berger, Humphrey and Pulley (1996) have found that they do not, on average, pay a premium for one-stop shopping. The implication is that either consumers do not value it or there is sufficient competition in the cluster or one-stop shopping market that banks cannot exact a premium for it.

[59] The FRB increases the weight it attaches to deposits at thrift institutions as a mitigating factor, once it has been determined that the 1800/200 threshold will be breached if thrift deposits are weighted at 50 percent.

[60]The theoretical and empirical support for this approach is discussed later in this study.

The threshold at which a merger is regarded as being potentially anti-competitive is derived from the DOJ/FTC Horizontal Merger Guidelines. These Guidelines apply to all industries but they have been modified slightly for use in connection with banking mergers. This threshold is expressed in terms of the effect of the proposed merger on the Herfindahl-Hirschman Index (HHI). The HHI is a measure of market concentration. It is the sum of the squares of the market shares of the competitors in the market.[61] It increases as the number of competitors in the market decreases and as their respective market shares become more unequal.

For mergers outside the banking industry, there is a (fairly) safe harbour for mergers that *either* increase the HHI by less than 50 points *or* result in a post-merger HHI below 1800. A merger between two firms each with 5 percent of the market would increase the *pro forma* HHI by 50 points.[62] The change in the HHI resulting from a merger is equal to twice the product of the market shares of the merging firms.

The safe harbour for banking industry mergers is slightly more generous. Neither the FRB nor the DOJ would have competition concerns over a merger if either the post-merger HHI in the relevant market is less than 1800 or if the merger would raise the HHI in the relevant market by less than 200 points. The majority of local banking markets in the United States are already over the 1800 threshold.[63] A merger between two firms each with 10 percent of the market would increase the HHI by 200 points. The combined pre-merger market shares likely to lie inside the safe harbour are as shown in Table IV.4.

Recall that the FRB and the DOJ define banking markets differently and, as a consequence, their market share and HHI calculations may differ somewhat. The FRB employs what is known as "Screen A." For purposes of Screen A, the FRB defines the size of the market to include 50 percent of the deposits of all thrift institutions and 100 percent of the deposits of all banks in the geographic market. Both the FRB and the DOJ are likely to examine in greater detail a proposed merger that exceeds the 1800/200 threshold using Screen A.

The DOJ also makes use of a second screen, Screen B. For purposes of Screen B, the size of the market is the sum of the deposits of all banks in the geographic market. Thus, Screen B differs from Screen A in that it excludes deposits at thrift institutions. The DOJ will proceed to the examination of the effect of a proposed merger on competition in the supply of commercial loans if the 200/1800 threshold under Screen B is exceeded.

In cases where Screen B indicates that further examination is warranted, the parties are advised to supply information on the commercial loans made by banks and thrift institutions in the relevant geographic market(s). The DOJ suggests that calculation of pre- and post-merger HHI's using

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[61] For example, if two firms share a market equally, the HHI is $50^2 + 50^2 = 5000$. If there are three firms with shares of 50 percent, 30 percent and 20 percent, the HHI is $50^2 + 30^2 + 20^2 = 3800$.

[62] Economic theory predicts and experience tends to confirm that the merged entity will suffer some attrition in its market share as customers seek out second sources of supply. Thus, the actual increase in both the merged entity's market share and the HHI is likely to be less than the predicted increase.

[63] Rhodes (1996, p.347) reports that in 1994, 137 out of 308 MSA (metropolitan) markets and 2,111 out of 2,283 county (rural) markets had HHI's in excess of 1800.

data on commercial and industrial loans (a) below $250,000 and (b) between $250,000 and $1,000,000 is also helpful in assessing the extent of competition in small business lending in the relevant market. Commercial loan HHI's may or may not provide much additional information in that the parties may, in some cases, have to estimate commercial loan shares using deposit shares.

In addition to commercial loan HHI's, parties in mergers exceeding the Screen B threshold are also asked to provide other information bearing on the relevance of Screen B including:

- evidence that a thrift institution is actively engaged in providing services to commercial customers particularly loans for business start-ups or working capital and cash management services;
- evidence that a credit union offers services to commercial customers;
- evidence of competition for commercial customers (particularly start-ups or working capital) by out-of market institutions;
- evidence of competition for commercial customers (particularly start-ups or working capital) by non-bank institutions.

The threshold at which competition concerns are triggered is set higher for the banking industry than in other industries in order to compensate for the exclusion of credit unions, finance companies, mortgage bankers and other local lenders or suppliers of financial services from the calculation of the size of the market.

The HHI is the sum of the squares of the market shares of all the firms competing in the relevant market. It is also equal to the inverse of the number of *equal-sized* firms competing in the market. Thus, a merger leaving six equal-sized banks competing in the relevant market implies a post-merger HHI of 1,667 (10,000 x 1/6) and would not be challenged by the FRB or DOJ. A merger of any two of six equal-sized banks would result in a post-merger HHI of 2222 and would increase the *pro forma* HHI in the relevant market by 555 points (10,000 x 2 x (1/6)x(1/6)) and, in the absence of appropriate divestitures, would be challenged by the DOJ and not approved by the FRB.

The FRB also provides for expedited (local) approval of mergers passing a further market share test. If the merged entity's market share is less than 35 percent, and either the post-merger HHI is less than 1800 or the change in the HHI due to the merger is less than 200 points, the merger can be approved by the responsible Federal Reserve Bank with no further analysis of its effect on competition. For example, a merger between banks with (just under) 25 percent and 4 percent of the market respectively would qualify for expedited approval (combined share, under 35 percent), HHI under 200).

If a bank merger raises the HHI by more than 200 points to a level in excess of 1800, the analysis of its effect on competition proceeds to the next stage. There are mitigating factors generally present in retail banking markets which allow for the approval of mergers just exceeding this threshold. The FRB has defined a second threshold beyond which these mitigating factors are unlikely to apply. For mergers increasing the HHI by more than 250 points *and* resulting in a HHI above 2200, FRB approval is highly unlikely. The mitigating factors are deemed likely to result in the approval of any merger which increases the HHI by less than 250 points or results in a HHI of less than 2200. If, in addition, the market share of the merged entity is less than 40 percent, there is a provision for expedited approval by the responsible Federal Reserve Bank.

The mitigating factors considered by the DOJ and FRB are as follows:

1. Potential Competition: Entry into the relevant market is relatively easy. Legal barriers to entry are low. Economic barriers to entry are low. Some markets may be unattractive for entry for conventional reasons – relatively small size and slow growth. There may also be economic barriers to entry that are specific to banking. These may include slow market penetration due to both the importance of reputations and relational contracts between consumers and incumbent firms.

2. Similarity between banks and thrift institutions in the market: Thrifts may be exercising their consumer lending, commercial lending and transactions account powers and thus be close competitors to banks. In this case the HHI would be recalculated assigning greater weight to thrift deposits. That is, instead of a 50 percent weight (Screen A), thrift deposits may be accorded a 100 percent weight and the post-merger HHI would be lower as a consequence. This may push the merger in question under the 200/1800 threshold.

3. The acquired bank is a weak competitor. Profitability and market share are indicators of competitive strength.

4. The market is declining and rationalization is required. Indicators of market growth or decline include population, income, deposits, employment as well as bank profitability. Closely held banks in rural areas may be very difficult to sell except to banks in the same geographic market. If there are no realistic outside bidders the FRB will approve a merger that violates the HHI threshold.

5. Competition from other depository institutions such as credit unions, industrial banks or cooperative banks or industrial banks is unusually intense. Lack of membership restrictions for credit unions and commercial lending nonbank depository institutions is especially important. It is suggested that the FRB may ultimately include credit union deposits in its HHI calculation although it is unlikely to give them full weight (Amel, 1997, p.15).

6. Competition from nondepository institutions or from banks outside the geographic market is unusually intense.

7. The acquired bank is otherwise likely to fail and less anti-competitive options for the purchase of the failing institution do not exist.

8. The resulting banking organization has less than $100 million in assets implying that significant economies of scale are possible. For banks of a larger size, potential efficiency gains are rarely regarded as important by the DOJ or FRB.

The market shares of merging banks which would not likely be challenged if mitigating factors were present are tabulated in Table IV.5. Mergers in the shaded area would be eligible for expedited approval by the relevant Federal Reserve Bank.

Issues in the Application of Merger Analysis to Banking

There has been considerable discussion in the United States regarding the application of merger analysis to banking. The point of this discussion is generally not that the merger criteria embodied in the *DOJ/FTC Horizontal Merger Guidelines* are incorrect. Rather it has to do with the interpretation of these criteria in the context of banking.

One area of discussion is the importance of the local geographic market as a basis of analysis. It is well established in the United States that while some product markets (wholesale banking) are national or international, retail banking markets are largely local at present. While it is conceded that electronic banking will serve to broaden geographic markets over time, the favoured approach remains one of beginning with a local market and broadening it as the facts of the case warrant.

A related issue is whether the concept of the local market is meaningful when it is dominated by multimarket bank holding companies. There are two questions here. Both are relevant to the Canadian scene. The first is whether bank holding companies vary their behaviour according to local market conditions. Banks may employ pricing manuals that apply uniformly in all markets, local market conditions notwithstanding. National or zone pricing is not uncommon (for list prices, transaction prices may be another matter) in other industries. Moreover, branch banks may face agency problems which oblige them to limit the discretion of local managers even if it does mean that they forfeit whatever advantages accrue from taking advantage of local market circumstances. While they accept the possibility that national pricing may be advantageous and that local discretion may have to be limited, most economists would have difficulty with the assertion that merger review should proceed as if local market characteristics did not matter. Rhodes (1996, p.350) reaction might be typical:

> Large, multimarket banks may indeed have price books that establish base prices on various services for all of their offices. Such price books would serve to provide guidance to local offices, maintain some centralized control over prices for various services, and implement strategies that may emphasize certain services over others (for example, increase mortgage loans and decrease business loans, or increase core deposits and reduced purchased money). However, common sense and profit maximization would suggest that it is probable that banks, like other retailers, would not adhere rigidly to book prices but would give local offices the latitude to account for local market conditions in setting prices.

The second question is whether the capacity of a bank holding company to respond to local market opportunities is best measured by its local market share. It is not inconceivable that a multimarket bank could divert resources from other markets to take advantage of opportunities presented by a merger of two of its local competitors even though its current market share is relatively modest. Of course, these resources have an opportunity cost in the form of their earnings in other geographic markets and the demand for them may be relatively inelastic. Moreover, if human capital transfers are also required, the extent to which funds can simply be shifted from market to market might be further reduced. The competitive significance of out of market resources has been investigated after a fashion in the U.S. empirical literature.[64] This is discussed further elsewhere in this study.

A second issue which has been addressed at some length by U.S. commentators is the importance of barriers to entry into banking and whether these barriers have declined significantly. Legal barriers to entry have been reduced markedly. It is argued, however, that economic barriers to entry into some retail banking markets remain significant. Rhodes (1997, p.9) lists four lines of retail business into which entry may be difficult: (1) transactions accounts; (2) insured savings deposits; (3) cash services and; (4) small business loans. Legal barriers to entering some of these markets relate to access to clearing and deposit insurance. Securitization and credit scoring may ultimately reduce barriers to entry into local small business loans markets in the U.S. but have apparently not done so yet. In Rhodes' view, potential economic barriers to entry in the form of switching costs and site preemption continue to exist in these retail banking markets. Empirical evidence (discussed elsewhere in this study) is consistent with a conclusion that local banking markets in the United States have not been contestable in the past.[65] The issue, of course, is which, if any, lines of business can be regarded as contestable now or in the near future.

A third issue is the interdependence paradigm and its relevance in banking. The *DOJ/FTC Horizontal Merger Guidelines* suggest characteristics of markets that may be vulnerable to the interdependent exercise of market power once the concentration threshold has been exceeded. The approach in the *Guidelines* (this approach is also taken by the Competition Bureau in Canada) is to look for conditions conducive to coordinated action and to detection and punishment of deviation. Coordinated action is more likely among firms producing homogeneous or at least very similar products under similar cost conditions. Knowledge about the cost conditions and customers of rivals is also important. Rapid detection and punishment of deviation are more likely if prices, output and other relevant terms of sale of rivals are known or can readily be inferred from changes in market share. The latter is more likely to be possible in the presence of stable demand comprised of a large number of repetitive purchases, stable costs and non-strategic customers. Mavericks with small market shares but the potential for significant output expansion may also destabilize a cartel.

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[64]Wolken and Rose (1991) find that fringe bank out-of market capacity has no effect on the profit margin of the dominant local bank. The study is flawed in many respects.

[65]One especially interesting study (DeYoung and Hasan, 1997) examines the profitability of *de novo* entrants into local bank markets. They find that it takes nine years for a new entrant to become as profitable as similar-sized established banks. This foregone profit is a sunk entry cost.

While some of these factors appear to be present in retail banking, U.S. authorities have not been obliged to argue an interdependence case in banking because the parties inevitably agree to a divestiture that takes their merger below the threshold at which a possible increase in interdependent behaviour would have been inferred. These factors bear on the probability of successful, sustained collusion. They imply little about the effect of a merger on this probability or about the effect of successful collusion on customers or on the economy. In their attempts to quantify what is essentially a qualitative approach to the determination of the anti-competitive effects of a merger, U.S. commentators frequently rely on statistical evidence of a relationship between market concentration and profitability both in general and in banking. This evidence is examined briefly in Section VI.

Remedies

While some merger proposals are denied outright, this is very rare. The FRB has denied two proposed mergers in the last four years. Both involved proposed acquisitions of thrift institutions in rural markets by banks. Both were denied because the parties declined to make the divestitures that would have addressed the competition concerns of the FRB.

In most cases, a remedy in the form of the divestiture of branches is adopted. Of course, customer accounts (deposits, loans, related assets and personnel) are divested along with the branches. The FRB is principally concerned that divested branches are viable. The DOJ has the further concern that divestitures be such as to maintain competition in lending to small business. In this vein, it has generally specified that large incumbents were not suitable purchasers for divested assets. This has left smaller incumbents and out-of-market firms as potential acquirers. Divestitures have been successful in that the divested businesses have maintained their market share (Guerin-Calvert, 1996, p.317). Depending on the role ultimately taken by foreign banks in retail banking, the remedial approach taken in the United States could be much harder to effect in Canada.

Table IV.1A
Percent of U.S. Households Using Various Types of Institution
By type of institution and selected institution characteristic

Type of	All	Primary	Local (< 30	Nonlocal (> 30 miles)
All	100	100	98.3	35.7
Depository	98.9	96.5	97.5	20.2
Commercial bank	83.3	71.3	80.6	11.3
Savings	29.5	13.4	26.5	4.3
Credit union	31.8	11.8	26.8	6.6
Nondepository	35.7	3.5	20.3	20.7
Finance company	13.1	1.7	6.2	7.8
Brokerage firm	16.3	1.0	10.7	7.3
Other	12.2	0.8	4.6	7.8

Table IV.1B
Percent of U.S. Small Businesses Using Various Types of Institution
By type of financial institution and selected institution characteristic

Type of institution	All	Primary	Local (< 30	Nonlocal (> 30 miles)
All	100	98.5	93.3	16.9
Depository	98.7	93.5	92.4	7.6
Commercial bank	91.4	83.9	84.9	6.4
Savings	12.1	7.7	10.9	0.8
Credit union	4.4	1.9	3.6	0.4
Nondepository	34.9	4.3	13.5	10.8
Finance company	13.4	1.4	3.8	4.1
Brokerage firm	9.9	1.0	5.9	2.3
Leasing	8	0.5	2.4	3
Other ND financial	3.7	0.2	1.1	0.8
Nonfinancial	8.7	1.1	1.4	1.4

Source: Kwast, Starr-McCluer and Wolken (1997).

Table IV.2A
Number of Miles Between U.S. Households and Their Institutions
By type of financial service

Type of service	Distance in miles by percentile			
	25th	Median	75th	90th
Asset	<1	3	8	50
Checking	<1	2	5	12
Savings	<1	3	8	50
Money market	<1	3	10	50
Certificate of deposit	<1	3	6	20
IRA or Keogh	2	5	25	50
Brokerage	4	10	50	50
Trust	3	15	50	50
Credit	2	7	50	50
Mortgage	3	8	50	50
Motor vehicle	2	7	22	50
Line of credit	<1	3	10	50
Other loan	2	10	50	50

Note: Distances are recorded up to a maximum of 50 miles.

Table IV.2B
Number of Miles Between U.S. Small Businesses and Their Institutions
By type of financial service

Type of Service	25th	Median	75th	90th
Asset	1	2	5	15
Checking	1	2	5	13
Savings	1	2	6	17
Credit	1	5	25	264
Lines of credit	1	4	11	45
Leases	5	39	431	1,214
Mortgage loan	1	4	12	35
Equipment loan	1	5	35	494
Motor vehicle loan	2	6	25	137
Other loan	1	4	12	139
Financial management services	1	3	10	55
Transaction	1	2	5	20
Cash management	1	3	10	30
Credit related	1	3	14	74
Pension	3	7	21	250
Brokerage	3	7	24	216

Source: Kwast, Starr-McCluer and Wolken (1997)

Table IV.3A
Average Number of Financial Services Used Per U.S. Household at Local and Nonlocal Institutions
By type of institution

Type of institution	All	Local (< 30 miles)	Nonlocal (> 30 miles)	Local institutions as a percent of all services
All	4.24	3.58	0.66	84.4
Depository	3.53	3.20	0.32	90.7
Commercial bank	2.23	2.07	0.16	92.8
Savings	0.63	0.57	0.06	90.5
Credit union	0.67	0.57	0.1	85.1
Nondepository	0.71	0.37	0.34	52.1
Finance company	0.18	0.08	0.1	44.4
Brokerage firm	0.37	0.23	0.14	62.2
Other	0.16	0.06	0.1	37.5

Table IV.3B
Average Number of Financial Services Used Per U.S. Small Business at Local and Nonlocal Institutions
By type of institution

Type of Institution	All	Local (< 30 miles)	Nonlocal (> 30 miles)	local institutions as a percent of all services
All	3.11	2.78	0.32	89.4
Depository	2.45	2.32	0.13	94.6
Commercial bank	2.19	2.07	0.12	94.7
Savings	0.2	0.19	0.01	95.2
Credit union	0.07	0.06	0.01	90.3
Nondepository	0.61	0.34	0.24	55.1
ND financial	0.48	0.27	0.19	56.1
Finance company	0.18	0.08	0.09	46
Brokerage firm	0.15	0.11	0.04	73.8
Leasing	0.11	0.04	0.06	39
Other	0.04	0.02	0.02	55
Nonfinancial	0.13	0.06	0.04	47
Source unknown	0.04	0.04	0	88.9

Source: Kwast, Starr-McCluer and Wolken, (1997).

Table IV.4
Bank Mergers Unlikely to Require Further Examination Using the FRB/DOJ Threshold

Market Share of Bank 1 (percent)	Market Share of Bank 2 (percent)	Combined Market Share (percent)	Δ HHI
2	50.0	52.0	200
3	33.3	36.3	200
4	25.0	29.0	200
5	20.0	25.0	200
6	16.6	22.6	200
7	14.3	21.3	200
8	12.5	20.5	200
9	11.1	20.1	200
10	10.0	20.0	200

Shaded area denotes mergers qualifying for expedited FRB approval.

Table IV.5
Market Shares at Which FRB Approval likely After Consideration of Mitigating Factors

Market Share of Bank 1 (percent)	Market Share of Bank 2 (percent)	Combined Market Share (percent)	Δ HHI
2	62.5	64.5	250
3	41.7	44.7	250
4	31.3	35.3	250
5	25.0	30.0	250
6	20.8	26.8	250
7	17.9	24.9	250
8	15.6	23.6	250
9	13.9	22.9	250
10	12.5	22.5	250
11	11.4	22.4	250

Shaded area denotes eligibility for expedited FRB approval.

V. Bank Merger Evaluation in Australia and the United Kingdom

The Wallis Commission on the Merger Review Process for Bank Mergers in Australia

The need for industry-specific competition regulation was recently considered by the Wallis Commission in Australia. The Commission reasoned that in order to make a case for industry-specific competition regulation, it would have to be demonstrated that the merger standard under competition legislation (S.50 of the Trade Practices Act of 1974) was inappropriate either because it was too strict or not strict enough. In this regard, the Commission concluded that:

> The Inquiry's examination has found no substantive evidence for a different test.
>
> Rather, examination of the Australian financial system suggests quite the opposite. As noted throughout this Report, non-traditional suppliers, such as retailers, telecommunications companies and manufacturers, are presently entering the financial system. This convergence would make the practicality of administering a separate competition regime for the financial system extremely difficult. (1997, p.419)
>
> The Commission went on to recommend that:
>
> Section 50 of the *Trade Practices Act of 1974* should continue to apply to the financial system as to other sectors - so that a merger in the financial system is prohibited where, in a substantial market, a substantial lessening of competition would be likely to result. (p.419)

The test under S.50 of the Trade Practices Act is much the same as the test under Section 92 of the Competition Act in Canada.

The Commission further concluded that the Treasury should not have the power to override an ACCC decision or otherwise to regulate bank and insurance company mergers on competition grounds:

> Banking and insurance laws should be amended to clarify that the only competition assessment of a merger should be under the *Trade Practices Act of 1974.* (p.425)

Making the competition authority supreme in competition matters is of little consequence if prudential or other concerns are such that the specialized regulator is always likely to override the competition regulator. This issue was confronted by the Wallis Commission in its examination of whether the "six pillars policy" (mergers among the four major banks and two major life insurance companies would not be permitted by the Treasury) was justified by prudential concerns.[66] The concern as expressed by the central bank was that while a reduction of the

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[66]The four national banks or majors are National Australia, Westpac, ANZ and Commonwealth.

number of national banks to three would not raise prudential concerns, this might precipitate another merger leaving two national banks in the market and this would put Australia into "uncharted prudential waters" with respect to the management of failure. The Commission found this argument unpersuasive in that, although small by international standards, the national banks were already of a size that would limit the options for a purely domestic reorganization should one of them fail. This led the Commission to conclude that there were no prudential grounds for overruling the approval of a major bank or insurance company merger by the ACCC. It recommended that the six pillars policy should be rescinded leaving merger review solely in the hands of the ACCC. The Commission drew no conclusion, however, with respect to the decision the ACCC might make if confronted with a proposed merger among the four national banks. The Commission also concluded that, while restrictions on foreign control of the four national banks should be removed, it opposed any large scale transfer of ownership of Australian financial institutions into foreign hands (p.474).

The ACCC Decision on Westpac Banking Corporation-Bank of Melbourne Merger

General Approach

In assessing this merger proposal, the ACCC followed its usual analytical approach. It did not vary its approach in response to any perceived differences in structural and behavioural characteristics of the banking industry. The normal approach of the ACCC is similar to the approach followed by the Competition Bureau in Canada and the Department of Justice and the Federal Trade Commission in the United States. It involves the following steps:

- market definition in product, functional, geographic and time dimensions;
- application of market share and market concentration screens
  - unilateral market power screen: merged entity has more than 40 percent of the market
  - interdependent market power screen: merged entity has more than 15 percent of the market and the largest four firms have more than 75 percent of the market;
- determination of whether the exercise of market power can be constrained by import competition;
- determination of the ability of new entrants to constrain the exercise of market power;
- examination of other factors including
  - countervailing power

- availability of substitutes
- removal of a vigorous and effective competitor
- dynamic characteristics of the market
- likelihood of a sustained increase in profit margins as a result of the merger
- the nature and extent of vertical integration in the market.

The foregoing has two important implications. First, the ACCC's method of merger review is very similar to Canada's (its market share and concentration thresholds are marginally higher). Second, the ACCC did not alter its method of merger review in its examination of the Westpac-Melbourne merger.

Market Definition

The ACCC distinguished between large corporate banking (large corporate fund-raising, various forms of derivatives) and retail banking. It concluded that the proposed merger was unlikely to affect competition in large corporate banking which it regarded as being national or international in scope.

With respect to retail banking, the ACCC acknowledged that many consumers continue to purchase bundles of services from banks but it decided nevertheless to examine the effect of the merger in six product markets: (term) deposits, home loans, personal loans, small business banking and transaction accounts.

With respect to deposits, the ACCC included cash management trusts, building societies, credit unions and "friendly societies" in the market. It defined the geographic market as the state. The geographic market for home loans was defined to be national. With respect to personal loans, building societies, credit unions and finance companies were included in the market and the geographic market was defined to be regional.

Small business banking was defined as a cluster market (credit, transaction facilities, physical depository facilities, a banking relationship, credit card processing and electronic funds transfer). The geographic market was deemed to be localized (Melbourne metropolitan area) and state-based (Victoria) at the widest.

Credit cards were regarded as distinguishable from transaction deposits and personal loans. The geographic market was held to be state-wide. Transaction accounts (chequing accounts) can be provided only by institutions with access to clearing facilities (banks, credit unions, building societies). Despite the growth of ATM's, consumers continue to make use of bank branches. For this reason, the geographic market was deemed to be the state.

Concentration Screen

For each of the relevant geographic and product markets defined above, the ACCC calculated market shares and four firm concentration ratios. The results of this exercise are summarized in Table V.1 at the end of Section V. In the case of small business banking, the measure of market size and shares adopted was small business loans. The small business loan share of the merged entity used was for metropolitan Melbourne although the geographic market was the entire state of Victoria. Data on credit cards were not available so that data on transaction accounts were used to calculate credit card market shares and concentration. The reasoning was that 80 percent of transaction account holders also have credit cards with the same bank. A further problem was that one of the parties in the merger did not actually issue a credit card and it was not possible to measure the market share of its debit card which was regarded as a partial substitute.

Factors Affecting Competition

Given that the threshold at which the interdependent exercise of market power was possible had been crossed, the ACCC turned to the analysis of import competition. The ACCC reasoned that the continuing importance of local branches was such that the potential market penetration of foreign (or even out of state) competitors with no branches would be limited. The Commission noted that there were numerous impediments to widespread Internet banking and that telephone banking had failed to gain appreciable customer acceptance. The ACCC also noted that the importance of brand names and the relational nature of many banking transactions also limited the speed with which imports could penetrate domestic markets.

Given the limited ability of imports to constrain the interdependent exercise of market power, the ACCC proceeded to the examination of barriers to entry into the relevant markets. The Commission found that there are significant barriers to entry into these markets. The barriers identified by the ACCC are as follows:

1. There are significant fixed entry costs. New entrants require a banking license and must meet prudential regulatory requirements.

2. Access to both branches and electronic banking is crucial in the consumer's choice of a supplier of retail banking services. The ACCC recognized that there are two views about branch networks. One is that they constitute an insurmountable barrier to retail entry. The other is that they are an anachronism and a handicap to incumbents. The Commission concluded that while the nature of bank branches will evolve and that electronic networks plus limited service kiosks in supermarkets (unless they are pre-empted by incumbents) or elsewhere may reduce entry costs into household banking, full service branches will continue to be important, particularly for small business customers.

3. Access to electronic banking may be difficult for new entrants. New entrants would have to incur significant costs to establish their own ATM networks or to negotiate access to the ATM's of incumbents and interchange fees may be significant (this issue has been addressed in Canada). A new entrant would have to secure acceptance of its EFTPOS

cards and if it wishes to offer a full range of services to merchants, it would need to be an EFTPOS merchant acquirer (this issue has been addressed in Canada).

4. There may be a banking premium resulting from a perception among consumers that banks are safer.

5. The vast majority of customers consider a bank to be their primary financial institution and they do not switch financial institutions frequently. Impediments to switching include information costs, maintaining credit standing and travel costs. This makes penetration of the market by a new competitor slow and therefore costly.

6. Economies of scale and scope realized through large multiproduct branch networks were regarded by the Commission as crucial in markets for transaction accounts, credit cards and small business banking.

7. Brand awareness is important in retail banking particularly if there is a recent history of financial institution failures. This again reduces the rate at which a new entrant can penetrate a market and thus increases the cost of entry.

8. The cost of entry has a large sunk component. If entry fails, much of the expenditure on entry will not be recovered. Sunk costs may be less if entrants have access to specialized suppliers of electronic infrastructure services and of back office services, if entrants have a pre-existing network of offices (insurance companies) and if entrants have an established, transferable brand name (foreign banks, insurance companies).

Having concluded that barriers to entry into some retail banking markets were substantial, the Commission proceeded to examine other relevant factors. It concluded that retail banking customers have no countervailing power. The Commission concluded that existing competitors (Commonwealth banks) could readily expand the supply of financial services in the state of Victoria. It concluded that the Bank of Melbourne had been a vigorous and effective competitor.

With respect to the dynamic characteristics of the market, the Commission considered the declining share of bank deposits in household assets, the increased use of electronic banking, regulatory change, back office joint venturing, entry of new suppliers such as mortgage originators and several other factors.

The Commission also considered whether the proposed merger would result in higher prices or margins. This involves, first, a determination of the magnitude of any efficiencies which might be contingent on the merger. In this it is similar to the efficiencies defence in Canada. The Commission acknowledged that there were many sources of potential efficiencies, essentially as a result of rationalization and diversification, but remained sceptical largely on the basis of (possibly dated) U.S. evidence that efficiencies resulting from mergers tend to be overstated. A second issue addressed is the extent of interdependence. The Commission was of the opinion that the banks had tried to avoid competing on price wherever possible and that the retail market had characteristics conducive to collusion. These included:

- a history of regulation;
- firms with similar cost structures (cooperative behaviour likely);
- inelastic demand for transaction accounts;
- a homogeneous product with transparent pricing;
- loss of the Bank of Melbourne as an independent supplier emphasizing low cost retail banking (in terms of transaction fees).

Militating against collusion was the expansion of non-bank suppliers and the dynamic factors cited above.

Conclusion

After consideration of the evidence in the context of its evaluative framework, the Commission concluded that there was a competition concern in only one of the six product markets it had examined, the transaction account market. The two other markets in which the concentration threshold had been exceeded, deposits and credit cards, were deemed ultimately not to pose a competition problem. The Bank of Melbourne was not a direct participant in the credit card market and there was sufficient innovation (disintermediation) in the deposit market.

In the transaction account market, the potential anticompetitive effect took the form of an increased risk of interdependent (i.e. collusive) behaviour. The Commission also concluded, however, that its concerns in this regard would be alleviated by undertakings on the part of Westpac that, for a period of three years, it would operate the Bank of Melbourne (BML) autonomously, maintain some of the BML's fees and services and give new competitors in the state of Victoria access on terms deemed acceptable by an outside adjudicator (if necessary) to Westpac's national ATM and EFTPOS networks and BML's electronic network.

The Treasury subsequently approved the merger. In so doing, it stated that it was accepting the advice of the Reserve Bank of Australia that the merger raised no prudential concerns and the advice of the ACCC that its concerns regarding competition had been alleviated by undertakings on the part of Westpac.

Implications for Canada

The competitive implications of this merger were examined solely by the ACCC. There was no parallel examination of the impact of the merger on competition by the Treasury or other regulators. In its examination of the merger, the ACCC used its standard methodology. It was not deemed necessary to develop and employ special standards for bank mergers. The Commission's methodology was able to accommodate the unique features of competition in retail banking markets. Banks may be different than other firms and banking markets may be

different from other markets but this need not imply that mergers in banking need to be assessed by different means or with different standards or by different adjudicative bodies. All markets have their own special characteristics.[67]

The Commission's concerns about a lessening of competition in the supply of transaction accounts in the state of Victoria were allayed by undertakings on the part of the merged entity. This would likely involve a consent order in Canada. The undertakings to operate BML autonomously and to maintain its pricing and service packages might not be acceptable to the Director or the Tribunal in Canada. These bodies would probably want a more self-enforcing set of remedial measures. They would find the ATM/EFTPOS access provisions for new entrants an acceptable although this would not likely be necessary in Canada as a result of the Interac case.

The Commission's decision not to oppose the merger in the light of the undertakings was accepted by the Treasury. The Treasury also accepted the central bank's recommendation with respect to prudential concerns. The Treasury apparently did not raise any competition or prudential issues of its own. Nor did it raise any employment, regional development or other issues. While Australians are probably as concerned about jobs as any other country, they may have recognized that merger review is not the appropriate occasion on which to voice and act on these concerns.[68] It is unlikely, however, that the Director or the Tribunal in Canada would be able to dismiss efficiencies arguments as readily as did the ACCC.

Competition Law and Banking in the United Kingdom

Banks and building societies in Britain are subject to the same competition law as other sectors of the economy. There are no special provisions or exemptions for the financial services industry. In particular, the merger provision of the Fair Trading Act of 1973 apply to banks and other financial services firms in the same way as they do in other industries. If he has competition concerns about a merger, the Director General of Fair Trading may recommend to the Secretary of State for Industry that the merger be referred to the Mergers and Monopolies Commission (MMC) for review.

In recent years a number of mergers involving banks have occurred in Britain.[69] Most of these mergers have not raised sufficient competition concerns to warrant an MMC investigation. There has been only one banking merger referred to the MMC by the Director General. That was the Lloyds Bank-Midland Bank merger in 1992. This merger raised competition concerns in three markets – factoring, merchant acquiring and small business lending. The MMC terminated it's investigation after the Lloyds Bank bid for Midland was rejected in favour of a bid by the

[67]At no point in the analysis were concerns expressed regarding increased incidence of tying or cross-marketing as a result of the merger. Australian banks do have the right to engage in asset leasing.

[68]The Wallis Commission did did not rule out the consideration of employment issues by the ACCC. It stated (p.468) that in the event that a bank merger was found to be in violation of Section 50, the ACCC could consider employment issues in determining whether the public benefits of the merger were such as to warrant its authorization. Public benefits tests are discussed in Section VII.

[69]These include Abbey National-National & Provincial, Bank of Ireland-Bristol & West, Natwest-Gartmore and Halifax-Clerical Medical all in 1996 and RBS-Birmingham Midshires in 1997.

Hong Kong and Shanghai Bank. This merger did not raise competition concerns. In 1995, the Office of Fair Trading examined the merger between Lloyds Bank and TSB Bank. The Director General concluded that it did not raise sufficient competition concerns to warrant an investigation by the MMC .[70]

When examining banking mergers, the Office of Fair Trading has defined product markets, at one level, by separating personal and business banking and, at a second level, in terms of such lines of business as loans, mortgages, current accounts, deposit accounts, merchant acquiring and factoring. Geographic markets have tended to be defined nationwide. Reasons given for this include the involvement of national supermarket chains in banking and the rise of telephone and related forms of banking.[71] Internet banking has yet to become and issue. Nor have "too big to fail" arguments.

The Office of Fair Trading also has the authority to investigate allegations of abuse of dominance (dominance requiring a 25 percent market share) or abuse of joint dominance (called a complex monopoly). If the Director General of Fair Trading finds that abuses are occurring, he can refer the matter to the MMC or he can negotiate undertakings with the party or parties.

One aspect of banking activity that has been referred to the MMC under the abuse provisions of the Fair Trading Act of 1973 is the credit card business. The MMC investigated the credit card business in 1980 and found that the practice of prohibiting participating merchants from giving discounts for cash or means of payment other than credit card (no discrimination clause) was anti-competitive. The government of the day declined, however, to prohibit this practice. The two card acquirers did, however, undertake to cease discussions they were having regarding credit card terms and conditions.

In 1987, the Director General again took concerns regarding the practices of credit card acquirers to the MMC. In its 1989 report, the MMC again found that the no discrimination clause was anti-competitive and again recommended that it be prohibited. The government accepted this recommendation and the prohibition took effect in 1991. The MMC also recommended that restrictions on entry by card issuers into card (merchant) acquisition should be loosened. The recommendation was accepted by the government making it possible for firms intending to issue cards also to become acquirers

With regard to the British experience enforcing competition law in financial services industries in general, observers concluded that although concentration is high in a number of product markets, there is adequate competition and relatively little in the way of anti-competitive behaviour has come to light. This is attributed, in part to the openness of the market to non-U.K. banks, to competition from building societies and to the entry of supermarkets into financial services retailing.

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[70]Lloyds TSB is now the fourth largest bank in Britain in terms of assets. It has 2,700 branches, the most in Britain. It has the largest share of the personal current accounts market with approximately 27 percent.

[71]The existence of national chains does not itself make markets local. It may, however, make it a matter of indifference as to whether competition is analyzed locally or nationally involved to remedy the abuses.

Table V.1

Application of Market Share/Concentration Screen: Westpac-Melbourne

Product Market	Geographic Market	Market Share	Four Firm Concentration	Conclusion
Deposits	Victoria	18.7	78.2	Interdependence Possible
Home loans	National	17.8	62.0	No Issue
Personal loans	Victoria	7.0	---	No Issue
Small Business Banking	Metropolitan Melbourne	10.9	87.7	No issue
Credit Cards	Victoria	19.9	91.1	Interdependence Possible
Transaction Accounts	Victoria	19.9	91.1	Interdependence Possible

VI. Market Power Issues

Empirical Evidence on the Exercise of Market Power in Banking

Most of the empirical evidence on the consequences of market power in banking comes from the United States. There are five types of empirical studies of the exercise of market power in banking. These are:

1. Traditional structure-profitability relationships;
2. Structure-spread relationships;
3. Structure-profitability relationships holding efficiency differences constant;
4. Relationships between mergers and changes in spread;
5. Nonstructural tests for price-taking behaviour.

Traditional structure-profitability relationships test the hypothesis that profit rates (rates of return on assets or equity or price-cost margins) are increasing functions of market share and market concentration. A positive relationship between profitability on one hand and market share and market concentration on the other has been interpreted as implying that banks with larger markets shares and/or in more concentrated markets have the ability to increase prices and thus their profits (Hanweck and Rhodes, 1984; Rhodes, 1985; Rose and Wolken, 1991). It turns out, however, that there is an alternate interpretation to this relationship. The alternate interpretation is that firms may have higher market shares and higher profits because they are more efficient. If more efficient firms have a greater share of the market, the market will, by definition, also be more concentrated. This is now well-known and the earlier adherents of this methodology now concede that it is not appropriate (Rhodes, 1996).

There have been a number of attempts at respecifying structure-profitability models so that they do imply something about the relationship between market concentration and the exercise of market power. One approach is to examine the relationship between market structure and the spread between loan and deposit rates. Interbank differences in efficiency should not matter here. That is, while more efficient banks should have higher profits and larger market shares, there is no reason to believe that they should pay less for deposits and/or charge more for loans. Indeed, if it is efficiency differences rather than market power which is at play then spreads should be lower in concentrated markets.

Rhodes (1996, p.358) assesses empirical concentration-spread studies as having found a positive price-concentration relationship. The sophistication of these studies has increased over time. A recent study by Berger and Hannan (1997) find that, given their efficiency, banks in more concentrated local banking markets tend to pay lower interest rates on deposits and charge higher interest rates on loans. This they take to be strong support for the market power hypothesis. Goldberg and Rai (1996) use a similar methodology to investigate the relationship between national market concentration and the spread (net interest margin) among the largest banks in

eleven European countries. They find no relationship between a bank's net interest margin and the concentration of the national market in which it operates. They do find a relationship between a bank's market share and its net interest margin. This result has a variety of interpretations. It may say something about the characteristics of the loan portfolios of the banks with the largest markets shares or about their relative attractiveness to depositors or about their relative reliance on service charges.

Another approach to the specification of structure-profitability models is to try to hold the effect of interfirm (interbank) differences in efficiency on profits constant in order to isolate the effect of market concentration on profits. This approach is taken in Berger (1995), Berger and Hannan (1997) and, in a European context, by Goldberg and Rai (1996).

Berger (1995) finds that, holding interbank differences in efficiency constant, there is no relationship between the profitability of a bank and the concentration of the market in which it operates. This does not support the hypothesis (underlying the Guidelines) that, as a market becomes more concentrated, the joint exercise of market power is more likely. Berger also finds that, given interbank differences in efficiency, there is a positive relationship between a bank's market share and its profitability in roughly one-third of the cases he examined (1995, p.416). This suggests to Berger that the larger banks in a local market can command a premium for their products due to brand recognition, locational or other advantages. That is, the largest banks in a market have advantages in addition to the advantage derived from being more cost-efficient. The existence of locational and brand recognition rents is not surprising.

Berger and Hannan (1997) also estimate the multivariate relationship between the profit rate of a bank on one hand and, on the other hand, its relative efficiency, its market share and the overall concentration of the market in which it operates. They find no relationship between market concentration and profitability. Depending on the data they use, the authors find either no relationship between market share and profitability or a relationship that is marginally significant statistically. Thus, the authors find little or no support for the hypothesis that, given efficiency, banks with higher market shares and/or in more concentrated markets earn higher rates of return. They do, however, find that banks in more concentrated markets pay less on deposits and charge more for loans (see above). The authors interpret these two results as support for another hypothesis which they call the quiet life hypothesis. According to this hypothesis, profits from the exercise of market power are dissipated in the form of a quiet life for bankers so that the rewards of concentration do not show up in the form of higher observed profit rates. While the more efficient banks in any market have a bigger share of that market, banks in concentrated markets charge higher prices and have higher costs as a group than banks in less concentrated markets.

Goldberg and Rai (1996) also estimate the multivariate relationship between the profit rate of a bank (return on equity) on one hand and, on the other hand, its relative efficiency, its market share and the concentration of the national market in which it operates. Their sample is large banks in eleven European countries. They find no relationship between market concentration and return on equity. They find a strong positive relationship between market share and return on equity. This, taken together with their finding (above) of a positive relationship between market share and net interest margins, implies that there is some advantage accruing to the largest banks

in European national markets which shows up in higher spreads and rates of return. As these authors note, however, the common feature of studies such as these is their lack of robustness. Data and hypotheses are being tested simultaneously.

A third alternative to estimating a traditional concentration-profits relationship is to examine the price effects of mergers in banking directly. A recent paper by Hannan and Prager (1997) takes this approach to mergers among U.S. banks. They find that over the period 1992-94, participants in large horizontal mergers and their competitors reduced the rates they paid on deposits more (or increased them less) than did banks located in the markets where there were no large horizontal mergers. The authors experiment with alternate definitions of a large merger. They find that mergers resulting in changes in the HHI in excess of 200 points and occurring in markets with a post-merger *pro forma* HHI of at least 1700-1900 have the largest negative effect on deposit rates. They interpret this result as implying that the thresholds in the FRB/DOJ concentration screen have been appropriately chosen. This would appear to have some important implications for Canadian enforcement policy. Specifically, they imply that conventional (*Merger Enforcement Guidelines*) concentration and market share thresholds, appropriately modified to take into account possible underestimation of market size, are also appropriate for bank mergers.

Akhavein, Berger and Humphrey (1997) have also assessed the effect of "megamergers" on loan and deposit interest rates in the United States. They find that interest charged by merging banks fell relative to their peer group after the merger. Interest paid on deposits also fell relative to the peer group. Both changes are small and not statistically significant. These small and inconsistent effects of market power are not surprising to the authors. The mergers they were examining were largely of the market extension variety with relatively small local market overlaps. Changes in local market HHI's as a result of these mergers averaged 45 points (1997, p.42). The Hannan and Prager (1997) results are probably the more informative of the two studies.

A final type of empirical study of the exercise of market power is what is known the non-structural approach. Instead of attempting to find a relationship between market structure and profits or spreads, this approach tests for price-taking behaviour. In essence, it investigates whether banks respond to shocks as competitive firms would or as firms with monopoly power would. There are a number of different studies of this nature, some of which are Canadian.

Hannan and Liang (1993) postulate that if banking is competitive, the rate of return offered by banks on deposits should equal the rate of return they can earn on government securities (a market in which they are presumed to be price-takers) less the marginal cost of intermediation. Market power in the local deposit market implies that the rate of return offered on deposits will be less than the marginal netback on securities. The authors use a multiproduct bank cost function to estimate the marginal cost of servicing deposits. They find that deposit rates are generally lower than the netback on securities and this leads them to reject the argument that banks are price-takers especially in local markets for Money Market Deposit Accounts (MMDA's). Since they regard the supply of funds for MMDA's as the least elastic of the deposit accounts they examine, their results lead them not only to reject price-taking behaviour but also to conclude that the pricing of MMDA's is consistent with the monopsonistic behaviour, that is, offering the lower price to the less elastic source of supply. They also find that the monopsony

margin on MMDA's is greater in the more concentrated local banking markets. This is not true for 2 and 3 year CD's which implies to the authors that the geographic market for these deposits is broader.

A second type of non-structural model makes use of a result due to Panzar and Rosse (1987) that if a firm's revenue function does not depend on the optimizing decisions of rivals, then the sum of the respective elasticities of its revenue with respect to the factor prices it pays must be negative. This is true of monopoly even if the monopolist is facing a highly elastic demand. It is not true of monopolistic competition or perfect competition in the long-run and this is the value of this result as an empirical test for monopoly. In the simplest terms, if a monopolist's input prices go up, his profit-maximizing monopoly price rises, he sells less and his revenue declines.[72] In contrast, with perfect competition in the long-run, the firms remaining in the industry will just cover their costs so that revenue per firm must rise by the amount of any cost increase. Hence, the sum of the respective elasticities of revenue with respect to input prices for each surviving firm is one. This can also true of monopolistic competition if the representative firm's elasticity of demand does not depend on the number of rivals. If the elasticity of demand declines as the number of rivals decline, revenue may increase by a smaller percentage than input prices. Panzar and Rosse also show that in an oligopoly (small numbers) market, a change in factor prices can increase or decrease the revenues of individual firms.

Nathan and Neave (1989) have attempted to apply the Panzar-Rosse model to a cross-section of Canadian banks and trust companies. They find that, on average, the sum of the elasticities of revenue with respect to premises expense per branch, salary expense per worker and interest expense per dollar of deposit lies between zero and one. That is, financial institutions with higher unit input costs have higher revenues but not proportionately higher. The authors interpret their results as implying that individual financial institutions are neither perfect competitors nor monopolists. This is hardly surprising. Competition in financial intermediation is imperfect. This begs the question of whether it is somewhat imperfect or highly imperfect.

The empirical design of the Nathan and Neave study has been the subject of a variety of criticisms (Perrakis, 1991; Booth, 1995 and Heffernan, 1996). Nathan and Neave assume that banks are price-takers in the market for deposits. That is presumably one of the questions they were (or should have been) investigating. Both Perrakis and Heffernan reiterate that Nathan and Neave cannot draw any inferences regarding the intensity of competition once they have disposed of the polar cases of monopoly and perfect competition.[73]

A third non-structural test for price-taking behaviour has been suggested by Bresnahan (1982). Bresnahan's approach was effectively to see whether a firm's (or an industry's) price tracked its marginal cost over time or whether it was also influenced by factors that shifted or rotated the demand schedule. A systematic response by price to changes in these demand characteristics,

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[72]A profit-maximizing monopolist always operates in the elastic range of the demand function. In the elastic range, a price increase reduces revenue.

[73]Perrakis showed, in essence, that in the model underlying the empirical specification of Nathan and Neave, the elasticity of revenue with respect to input prices does not vary with the conjectural variations of the firms in the market. A firm's conjectural variation is a measure of its aggressiveness as a competitor.

given marginal cost, implies a departure from competitive, price-taking behaviour. Shaffer (1993) applied this test to a 25 year time series of observations on Canadian chartered banks in aggregate. He defined the price of output as interest income per dollar of assets. He defined output as assets in constant dollar terms. He assumed deposits were inputs and that banks were price takers in the market for deposits. Other input prices were constant dollar wages and salaries per employee and constant dollar expenditures on premises per branch. Shaffer finds that he can not reject the hypothesis that Canadian chartered banks as a group engaged in marginal cost pricing (price-taking or perfectly competitive behaviour) over the period 1965-89. This result is not persuasive. The specification is crude, the number of observations few and the assumption of price taking behaviour in the market for deposits probably unwarranted.[74]

Guidance from Theory

Economic theory provides relatively little guidance regarding the number of banks necessary in order to maintain competitive banking markets. If the market were perfectly contestable, then one would do. If the market is not contestable but rivalry is very aggressive, then two competitors would do.[75] If the market is not readily entered and rivalry is not particularly aggressive, mergers among incumbents may lead to higher prices and a net loss in surplus. This can occur even if mergers do not make cartelization easier.[76]

A number of simple decision rules have been developed regarding the types of mergers that are permissible or not permissible in industries where collusion is not a concern but which are characterized by barriers to entry. For example, MacAfee and Williams (1992) find that a merger that creates a new largest firm in the market will be welfare-reducing (and by implication should be challenged unless it results in offsetting synergies). Put another way, the McAfee/Williams decision rule would be that, absent synergies, any merger that creates a new largest firm in the market should be challenged.[77] The intuition behind this result is that in economic models of oligopoly, firms with lower costs have higher market shares. When two firms merge there is attrition in their market share. If the merging firms are relatively small, then share is shifting to larger, lower cost firms. If the merging firms are relatively large however, share shifts to smaller, higher cost firms. Other things equal, it is preferable to have mergers among the smaller firms in the market rather than among the larger firms.

Similar types of results have been derived in the context of industries producing differentiated products. For example, Werden and Froeb (1994) simulate potential mergers in the U.S.

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[74]Shaffer might have seen his finding that an increase in interest costs per dollar of deposits reduces the marginal cost of loans as an indicator that something was amiss.

[75]Highly aggressive rivalry is known in economic theory as Bertrand competition. Bertrand duopoly with a homogenous product has the same outcome as perfect competition.

[76]For example, Freixas and Rochet (1997, pp. 59-61) model the banking industry as a Cournot oligopoly. Their model predicts that the excess of the lending rate over the money market rate and the excess of the money market rate over the deposit rate are both inversely proportional to the number of banks.

[77]Put yet another way, unless there is a non-merging firm in the market with a pre-merger market share that is larger than the sum of the market shares of the merging firms, the merger should be challenged. See also Farrell and Shapiro (1990).

telecommunications industry. For the reasons just given they find that any merger involving the largest competitor (AT&T) has significant adverse effects on prices and welfare while mergers involving smaller rivals such as MCI and Sprint had very small adverse effects even if the merging firms realized no efficiency gains. Also in a differentiated products context, Werden and Froeb (1996) experiment with alternate market power screens to determine which best reflects the change in market power resulting from a merger. Werden and Froeb find that the change in the *pro forma* HHI is a much better indicator of the price, consumers surplus and welfare consequences of a proposed merger than is either the market share of the merged entity or the *pro forma* post-merger HHI. This may have implications for merger review in Canada which has tended to focus on the market share of the merged entity.

Determining the type of merger that is likely to lead to a significant increase in the likelihood of collusion is very difficult. The factors considered in the Canadian and U.S. merger guidelines distill much of the findings of economic research on this matter. There are some additional findings of interest. Phlips (1995) surveys the implications of cartel theory for competition policy. There are many different models and results. One interesting result addresses the question of the effect of the number of firms in the market on the probability that any one firm will choose to join a cartel agreement. In this model, that probability turns out to be one if there are four or fewer firms in the market and virtually zero if there are six or more (1995, pp. 23-38).

Another question of interest on which theory has something to say is whether multimarket contact facilitates cartelization. This issue is investigated by Bernheim and Whinston (1990) who attempt to formalize an older literature on mutual forbearance. They find that multimarket contact can facilitate collusion under various circumstances. This does not necessarily raise prices in all the markets involved and it is not necessarily welfare-reducing.

Evidence on the Effect of Bank Mergers on Small Business Lending

A natural concern arising as banks become larger and banking markets become more concentrated is that loans to small business will decline and small businesses will have more difficulty financing themselves. This may not have much to do with market power in banking. Given the difficulty of verifying their credit worthiness, however, small businesses (more correctly, new businesses) may face some credit rationing regardless of the amount of competition among lenders. A possible market power story might be that if the reward of market power is a quiet life, management of a bank acquiring market power might tend to withdraw from the more professionally demanding and risky activities first. Small business risk assessment may be such an activity. Another possible market power type story relating to risk assessment is that a second or a third opinion may be required in order to reduce the probability that truly credit-worthy borrowers will be incorrectly rejected.

Other scenarios are driven more by bank size. In this case, the argument is that as banks becomes larger they tend empirically to lend relatively less to small business. Banking consolidation therefore reduces lending to small business. One question about this is why this

would happen. Big firms may not be interested in small customers.[78] Another question is why some other lender does not move in to fill the vacuum created when a consolidating bank reduces its small business lending. This raises both competition and regulatory issues.

These questions are addressed by Berger, Saunders, Scalise and Udell (1997). The authors review existing U.S. literature on the effect of bank mergers on small business lending. They confirm that larger banks in the U.S. tend to devote a much smaller fraction of their assets to small business lending than smaller banks. They speculate that if banks in the U.S. were consolidated into institutions with assets of $10 billion or more and these banks adopted the current lending propensities of banks with assets of $10 billion or more, small business lending would be cut in half (1997, p.2).

Berger *et. al.* search for a theory which explains the effect of increased bank size on its portfolio:

> Theory suggests that the larger, more organizationally complex institutions that are created by M&A's may be less inclined than smaller, less complex institutions to lend to small, informationally opaque borrowers – the borrowers who are most dependent on banks for credit and for whom the bank-borrower relationship is most important. Large institutions may be less inclined to extend loans that demand intimate knowledge of the small business, its owner, and its local market because of Williamson type organizational diseconomies associated with producing such loans along with other financial service products. These diseconomies might arise because lending to small, informationally opaque borrowers and lending to large, informationally transparent borrowers may be distinctly different activities that require the use of different technologies and entirely different credit cultures. That is, the policies and procedures associated with screening and monitoring small, informationally opaque borrowers and transmitting the relevant information within the banking institution may be very different from those associated with providing transaction-driven loans to large, informationally transparent borrowers. In addition to a financial institution's size, its organizational complexity may also affect its small business lending. Greater organizational complexity – such as having multiple layers of management or operating in multiple states – may also make it more difficult to provide locally-based small business services in nationally – or internationally-oriented institutions. Together, these arguments suggest that large, complex banking institutions – whose core business is the provision of capital market financial services – may have difficulty competing against small, less complex banking institutions in the provision of the latter group's core business product – loans to small, informationally opaque borrowers. (1997, p.5)

The argument is, in essence, that big branch banks have an agency problem (is the local manager acting in the bank's interest or his own?) which requires them to limit the discretion accorded local managers in some areas. This militates against local initiative in these areas. Small banks do not the same agency problem although they may have others. This is a point that has been

[78]This is obviously not true in general. Coca Cola appears very interested in having me as a customer. It may not be a question of interest at all. It may be simply that, as far as their lending activity is concerned, small banks will, almost by definition, not have any big firms as customers.

made repeatedly when discussing the advantages and disadvantages of national branch banking. Whether this branch banking agency problem would be aggravated if existing large branch banks were to become bigger still is another question.

Berger *et. al.* rightly regard the argument that a hitherto profitable lending market will simply go unserved as banks consolidate as naive. Merging banks are unlikely simply to walk away from their small business customers. That is, the balance sheet of a $10 billion GTA bank that is the result of a recent merger between two $5 billion banks is unlikely to look the same as the balance sheet of a $10 billion GTA bank that has not been engaged in M&A activity (which is what estimates of declining small business lending assume). Indeed, while the evidence is mixed, it cannot be construed as supporting the notion that merging banks systematically walk away from their existing body of small business customers. They may, however, still allow this portion of their business to decline over time. This business could still be picked up by other banks or other lenders. This would depend in part on the openness of the market to entry of small lenders who would have an interest in replacing consolidating banks.

Berger *et. al.* break the effect of bank mergers on small business lending into four effects. The static effect is the naive model described above. Two $500 million banks combine and alter their lending so that their asset portfolio is the same as a $1 billion bank, that is, with a smaller fraction of assets devoted to small business loans. Then there are three potentially offsetting dynamic effects. First, there may be some attrition in the merged entity's business so that it is ultimately not a $1 billion bank but, say a $900 million bank. Its asset composition should reflect its actual post-merger size rather than its *pro forma* size. This would imply a smaller decline in the fraction of assets devoted to small business lending. Second, there is the direct effect. This reflects the extent to which the merged bank actually changes its strategy to shift away from small business lending. If there is no change in strategy, the merged entity will continue to resemble a $500 million bank rather than a $900 million bank in its asset composition. Third, there is the external effect which occurs when competing institutions expand to enter areas from which the merged entity has withdrawn. New entrants have historically been of importance in this regard (1997, p.11).

Berger *et. al.* find that the net internal effect of bank mergers on the proportion of assets devoted to loans under $1 million was negative. The net internal effect of acquisitions was nil.[79] In both cases there was also a large external effect with competing institutions expanding their small business lending activity by more than enough to offset the decline in small business lending resulting from mergers (1997, Table 8). Many of the six thousand mergers and acquisitions in their sample involved banks that were very small by Canadian standards. Mergers among the smaller banks had positive internal effects on small business lending. This was offset by mergers and acquisitions among larger banks (still small by Canadian standards) which had negative internal effects.

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[79]Recent results reported by Cole and Walraven (1998) support the Berger et. al. findings. In their fully specified model, Cole and Walraven find that the probability that a small business loan application will be denied is lower if the bank involved becomes an acquirer after the loan application and is otherwise unrelated to merger activity.

Whether these results can be extrapolated to the Canadian situation is doubtful.[80] The banks involved are bigger. Apparently, small business loan sizes are typically much smaller than $1 million. The small business-oriented local bank has not been an option for small business borrowers in Canada. Nevertheless, two important points remain. First, much of the discussion of the rationale for bank mergers in Canada focuses on the importance of larger size in seeking or retaining major international customers. The implication would appear to be that, consistent with the Berger *et. al.* findings, merging banks would devote a larger share of their combined assets to large customers and international business. Second, the environment in the U.S. has been very auspicious for the emergence and expansion of local, small business-oriented lenders. This may not be true of Canada.

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[80]Insofar as the direct effect of market power is concerned, Berger *et.al.* find that, other things being equal, the proportion of assets devoted to loans of less than $1 million increases with the concentration (measured by the HHI) of the local market involved (1997, Table A1).

VII. Efficiencies Considerations

Efficiencies Issues for the Financial Services Industry

The principal concern of this study regarding efficiencies is whether the merger review process as it is presently constituted gives proper consideration to efficiencies evidence in general and to the type of efficiencies that are likely to be realized in financial sector mergers in particular. In the event of a finding that the process as constituted does not or might not do so, the mandate of the study is to suggest ways in which the merger review process could be altered or restructured so as to take proper account of efficiencies arguments.

The dominant concern of firms in the financial services industry appears to be with efficiency and strategies for improving it. With respect to the emphasis on efficiency improvements, the submission of the Canadian Bankers Association (CBA) to the Task Force states:

> The increasing emphasis on efficiency drives market players to position themselves as the lowest-cost, best-service provider. This, in addition to other changes, such as the trend towards asset securitization in which banks have been actively participating, is fundamentally reshaping the financial services industry. This reshaping is characterized by a decline in some traditional banking functions (disintermediation) and by the unbundling(disaggregation) and rearrangement of the functions that remain into units of optimal size.

The CBA submission goes on to describe some of the many ways in which efficiency gains might be realized:

> No one strategy fits all institutions. Some North American institutions are focussing on building scale in specific market niches. Some examples are TD Bank in the discount brokerage market, Capital One Bank and MBNA Bank in credit cards, Wells Fargo Bank in small business loans and Mellon Bank in corporate trust services. Others are entering into strategic alliances and partnerships. For instance, Bank of Montreal, Royal Bank and TD Bank have formed Symcor to combine document processing operations. Similarly, CIBC and the Bank of Nova Scotia are working together to form Intria, a company created to provide technology and transaction support services, either on its own or in partnership with other leading-edge specialized service providers. Royal Bank has joined with IBM and 15 top U.S. banks to create Integrion, an organization in which the members share leading-edge home banking and electronic commerce technology.
>
> We are also witnessing consolidation and acquisitions in Canada: London Insurance Group's sale of Security First Group to Metropolitan Life, Great West Life's proposed acquisition of London Life, the merger of Imperial Life and Laurier Life, and the acquisition of National Trust by The Bank of Nova Scotia. Market niche alliances are developing, such as the alliance between Royal Bank and AT&T Capital Canada to lease

> equipment to small businesses, and the joint venture among Bank of Montreal, its U.S.-based subsidiary Harris Bank and BankBoston to compete in the U.S. credit card market. (p.23)

Efficiencies can be realized unilaterally, for example, by contracting out specialized functions to specialized suppliers. Efficiencies can also be realized through horizontal agreements of various kinds or mergers. Mergers and horizontal agreements may also pose competition issues. Competition law must then face the problem of encouraging both competition and efficiency.

Mergers as Sources of Efficiencies

One motive for merger is that it will enable the firms involved to realize efficiency gains of various sorts. Freedman and Goodlet (1997) provide a general listing of the potential efficiency advantages of large size:

> Current conventional wisdom suggests that a financial institution must be large to prosper in the future environment. This view is based on some or all of the following propositions. First, given technological requirements, it will be extremely expensive in the future to maintain a competitive infrastructure for delivering financial devices efficiently and only large institutions can manage these costs. Second, there are economies of scale in some parts of the operation that can be realized only by very large entities. Third, a successful financial institution will have to be large enough to provide all or most types of services to its customers in a sort of financial supermarket, either because of demand or to the advantage of economies of scope (or "synergies"). Fourth, an international presence is essential for success, and only large institutions can compete outside the domestic market. Fifth, large amounts of capital will be necessary to handle the kinds of transactions and provide the kinds of services demanded by some customers in the future. These propositions imply that the successful financial institution of the future will be a very large conglomerate, operating in an international context, and providing all or most types of services to its customers in a technologically advanced way. (pp. 17-18)

Economies of scale and scope are often cited as likely sources of efficiency gains. Economies of scale are defined to exist when the cost of production increases less than proportionately with the scale of production. If economies of scale exist in a product line, unit cost can be reduced by producing that product in greater quantities. Economies of scale frequently result from indivisibilities, that is, from costs that do not vary with the level of activity or are relatively insensitive to it. While the existence of indivisibilities can result in serious diseconomies of small scale production, successive increases in scale yield successively smaller savings in unit costs so that savings from this source are unlikely to motivate mergers among larger banks.

It is suggested that a function in which there are significant indivisibilities is technology adoption. The argument in this case is that the cost of acquiring, installing and learning to use some of the latest technologies is not only high in absolute terms but is also largely invariant with respect to the scale on which these technologies are used. The implication is that, unless they are able to acquire it jointly, smaller banks may simply not be able to avail themselves of these new

technologies. For those that do acquire them, the larger banks would have a unit cost advantage over the smaller ones. It is said that the recent consolidation of the custodial businesses of the banks and trust companies "... has been driven by the enormous capital spending required to upgrade the increasingly sophisticated technology used in custodial operations." (McFarland, 1997, p.B4)

Economies of scope are defined to exist when the cost of producing two or more product lines jointly is less than the sum of the respective stand alone costs of producing these product lines. In some cases, technology requires that two or more goods or services be produced jointly. These are known as joint products. In other cases, separate production is technically feasible but is more costly than joint production. This occurs when the same input can be used to produce a number of different products. A good example is what is known as a public input. A public input is not subject to congestion. That is, it may be used for many purposes simultaneously without being exhausted. Knowledge is a public input. So is reputation. A reputation for honesty and reliability might be applicable across a variety of financial services without being diminished. Similarly, the knowledge acquired in the provision of one financial service may be applicable in the provision of another. It is argued that the knowledge acquired in the provision of transaction accounts to small businesses can be useful in monitoring loans to these businesses.

Another source of economies of scope is what is known as a quasi-public input. A quasi-public input is one in which there is no congestion over some range of output. An example is an under-utilized bank branch. It could be utilized to sell other products. These needn't be financial services unless specialized bank staff also happens to be under-utilized. In this case, the sale of other financial services in the branch would make better use of both physical and human capital.

It is important to understand the distinction between economies of scope in production, sales and marketing functions and the effects of one stop shopping and multi-product pricing on demand. Even if there is no supply-side advantage to supplying two or more products jointly, customers may derive an advantage from dealing with one supplier at one site. There are further advantages from multi-product pricing. Retailers may "loss lead" some popular products in the expectation that customers so attracted will purchase other, higher margin products. It is questionable how effective this would be in the financial services sector but there likely are complementarities to exploit.

Efficiencies resulting from mergers frequently take the form of synergies. The realization of synergies involves the exploitation of the complementarity between the excess capacity of one firm and the deficient capacity of another. One or both parties has a capability the other needs but can't acquire in the market. The recent joint venture between the Bank of Montreal and Citibank Canada provides an example of potential synergies. The joint venture gives Citibank access to the Bank of Montreal's Canadian client base and it gives the Bank of Montreal access Citibank's capability of processing transactions worldwide (McFarland, 1997).

Efficiencies can also result from the rationalization of capacity. Again, the existence of excess capacity is the trigger. An example from banking would be the elimination of over-branching. Two banks may each have a number of branches in a given geographic area. Each branch is underused. The business of two or more of these branches could be accommodated by one

branch. Of course, each bank may be able to close some branches unilaterally. In other cases, however, closing a branch may effectively cede its business to the other bank. Neither bank may wish to do this and a stalemate may ensue. An agreement to engage in reciprocal branch closures could be an offence under Section 45 of the *Competition Act* while a merger might not be.[81] Another possibility would be various back office functions wherein the facilities of one of the parties are sufficient to handle the business of both parties or could be expanded to do so at a low incremental cost.

Much of the discussion regarding mergers among Schedule I banks is couched in terms of their need to be larger in order to compete in international markets. This argument may be made in general terms, to wit, that the relative size of the largest Canadian banks has declined over time. It may also be made in specific terms.

One specific advantage attributed to larger scale is the risk reduction through loan portfolio diversification. Given loan size, the larger is the bank, the more diversified its portfolio can be. The obverse of this is that a larger bank can make larger loans without incurring more risk. A related argument is that Canadian banks have insufficient capital to qualify as lead banks in syndicates making very large commercial loans. In essence, they are able to take on such a small portion of the largest loans that they are unlikely to be approached to serve as the lead bank. This is said to have two consequences. First, Canadian banks lose out on whatever differential rents may accrue to the lead bank in the syndicate.[82] Second, Canadian customers requiring these very large loans are obliged to deal with a syndicate in which their own bank is not the lead bank and this may result in a decline in the quality of service they receive.

A second specific advantage of large size relates to economies of specialization of human capital. The argument in this case is that individual Canadian banks may not have a sufficient number of customers with interests in specific countries to justify the acquiring country-specific expertise. Thus, their customers may be obliged to go to rival Canadian or foreign banks or others to avail themselves of the requisite expertise.

It is important to place arguments regarding the existence and magnitude of economies of scale and scope in the supply of financial services in perspective. There are apparent economies in some functions over some size ranges. Large size is not essential, however, for the achievement of shareholder value and it is the achievement of shareholder value (rather than sheer size) that economists normally see as being the appropriate objective for management to pursue. There are many strategies for achieving shareholder value. Some are niche strategies. These entail the usual advantages of specialization and flexibility and, perhaps uniquely to the financial services industry, they also avoid potential conflicts of interest. There are also more limited forms of

[81] The efficiencies realized in a merger could be taken into account in assessing a merger under the *Competition Act* while the efficiencies flowing from an agreement to engage in reciprocal facilities closures could not be used as a defence to a horizontal agreement under Section 45 or 49 of the *Competition Act*.

[82] Some maintain that all the return to organizational knowledge and human capital is derived from managing the syndicate. Participating lenders are simply providing funds at a bare competitive margin over the wholesale cost of funds.

specialization. For example, Lloyds TSB has earned very high rates of return by focussing on retail banking to the virtual exclusion of investment banking and international lending.[83]

Recent Evidence on Efficiencies in Banking

The literature on the determinants of efficiency in deposit-taking institutions is huge. Recent attempts to summarize it include Berger and Mester (1997) and Akhavein, Berger and Humphrey (1997). Most of the literature is of U.S. origin although an increasing amount relates to Europe. The literature addresses many different questions. One stream of literature investigates the existence of economies of scale and/or scope in banking. The general conclusion of the earlier studies of this question was that economies of scale and scope are exhausted by the time a bank reaches an asset size of $500 million.

Recent results are considerably different. Berger and Mester (1997) draw the following conclusions from their exhaustive study: [84]

> The basic result ... is that in every size class, the typical bank shows unexploited ray scale economies i.e., that the bank's product mix could be produced at lower average cost by increasing the scale of output. The mean scale efficiencies are around 80 percent, suggesting that approximately equal amounts of resources are lost because of scale and X-inefficiencies. In every size class more than 90 percent of firms are operating below efficient scale, and the mean t* [t* is the ratio of cost-efficient size to actual size] is between 2 and 3 for each size class, suggesting that the typical bank would have to be 2 to 3 times larger in order to maximize cost scale efficiency for its product mix and input prices.

Berger and Mester's report a complex set of results. Input prices and the optimal product mix vary from size class to size class as does the relationship between scale and "unit" cost. They find that there advantages of large scale in producing the product mix typically produced by small banks and that there are also advantages of large scale in producing the product mix typically produced by larger banks. Most banks tend to be under-sized for the output mix they are producing.

Berger rely on a simple summary measure of the cost advantages of large scale to illustrate their results. This is reported in Table VII.1 at the end of Section VII. The last column of the table provides the simplest indication of the range of bank sizes throughout which scale economies are realized in the form of the ratio C/GTA which is the ratio of costs to gross total assets. This ratio can be interpreted as average cost per dollar of assets. It falls consistently when moving into larger size classes. Berger and Mester note that this ratio is, if anything, biased against the larger banks, which typically have more off-balance-sheet guarantees and more loans per dollar of

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[83]"The Lloyds money machine" The Economist January 17, 1998, pp. 65-66.

[84] Berger and Mester use a variety of econometric models but their conclusions are based on a Fourier-flexible frontier profit function.

assets, which should raise average costs. The authors view the finding of declining cost per dollar of assets by size class as strongly supportive of their econometric results which also imply scale economies running out to the larger size classes of banks in the U.S. The C/GTA ratio for banks did not show this pattern in the 1980s. The pattern in the 1980s implied mild scale economies for asset levels below $1 billion and diseconomies for larger banks and this was consistent with econometric studies.

In order to assure themselves that economies of scale persist among the largest U.S. banks, the authors recalculated the C/GTA ratio using data on all U.S. banks (as opposed to their sample banks) and segmented the largest size class into $10 billion - $25 billion, $25 billion - $50 billion, and above $50 billion ranges. They find average costs to be decreasing in all size classes up through $25 billion, with an increase in average costs thereafter.[85] They conclude that they still find relatively robust evidence of scale economies well beyond the region usually found in studies using the 1980s data.

An important question is what has changed between the 1980s and 1990s that substantially raised the cost-efficient scale of U.S. banks. Berger and Mester find three plausible explanations. First, interest rates are lower in the nineties than they were in the 1980s. They suggest that the resulting reduction in interest expense (which accounts for most of costs) was proportionally greater for large banks than small banks, because a greater proportion of large bank's liabilities tend to be market-sensitive. Large banks often rely on wholesale purchased funds that pay market rates, whereas small banks typically rely more on core deposits with rates that do not vary one-for-one with open-market rates. If this is the explanation, the scale economies of the early 1990s may be transitory.

A second possible explanation considered by Berger and Mester for their scale economies result is that recent regulatory changes may have tended to favour large banks relative to small banks. In particular, the elimination of geographic restrictions on bank branching and holding company expansion during the 1980s and into the early 1990s may have removed some scale diseconomies and made it less costly to become large. For example, in the extreme case of unit banking, there are very severe diseconomies to becoming large without being able to have any branch offices to collect deposits, and such diseconomies would be removed by allowing statewide branching. Similarly, the removal of interest rate ceilings on core deposits during the 1980s likely raised costs more for small banks, which rely more on core deposits for their finding.

A third hypothesis is that improvements in technology and applied finance may have reduced costs more for large banks than for small banks. Improvements in information processing and credit scoring may have reduced the costs of extending small business loans and credit card loans more for larger banks. Similarly, improved automation may have allowed large banks to expand faster and at lower cost by setting up ATM machines in place of adding more expensive brick-and-mortar branch offices. Large banks may have also been better positioned to take advantage

[85]While this still implies scale economies only out to the size of the National Bank of Canada, the importance of this finding is that it illustrates, first, that potential scale and scope economies can change over time and, second, that given potential scale economies, observed scale economies can also vary over time as regulatory constraints vary.

of the new tools of financial engineering, such as derivative contracts and other off-balance-sheet activities. (1997, pp. 31-34)

These last two possible explanations are very important. The widely held and well-documented view that there are no significant scale economies in banking is of U.S. origin and is drawn from a period in which banking technology (both product and process) was changing less rapidly, U.S. banks were limited in the ways they could expand and in the additional financial services or products they could offer.

Another stream of literature investigates the efficiency consequences of mergers themselves. It concludes that, on average, mergers do not result in unit cost savings. They do, however, result in changes in the product mix of the merged entity toward loans and away from securities. This increases profits. The question is whether this involves a social gain. One way of looking at this is to view the increase in the fraction of assets devoted to loans as a consequence of a reduction in the cost of risk-bearing. This is a social gain (on the assumption that all other avenues of risk reduction were fully exploited). The increase in "profit-efficiency" is most pronounced when the merging banks are both relatively inefficient but the acquired bank is somewhat more so.

Akhavein, Berger and Humphrey (1997) draw the following conclusions from their recent study on the cost and profit efficiency consequences of bank mergers:

> ... the findings suggest that there are statistically significant increases in profit efficiency associated with U.S. bank megamergers on average, although there do not appear to be significant cost efficiency improvements on average. The improvement in average profit efficiency in part reflects a product mix shift from securities to loans, increasing the value of output. The data are consistent with the hypothesis that megamergers tend to diversify the portfolio and reduce risk, which allows the consolidated bank to issue more loans for about the same amount of equity capital, raising profits on average. The profit efficiency improvements can be fairly well predicted – they tend to occur when either or both of the merging firms are inefficient relative to the industry prior to the merger.

It is important to understand that profit efficiency can improve without any change in the prices of inputs and outputs. Profitability can increase at a given set of prices by moving toward a more profitable (higher margin) product mix. In fact, the authors find that the changes in market power associated with megamergers – as reflected in changes in prices subsequent to the mergers – are very small on average and not statistically significant, although they are predictable to some degree. These results are what we would expect given that the so-called megamergers in the United States have been largely market extension mergers and, in any event, the antitrust authorities have required divestitures and other remedies for mergers they deem likely to increase market power.

The finding that mergers enable banks to take on higher margin (riskier) loan business is consistent with the arguments of the Schedule I banks that larger size would enable them to take on larger shares of large loans and be able to manage large loan syndicates more frequently.

There is a parallel, lengthier and better known empirical literature on the effect of bank mergers on cost efficiency.[86] This literature confirms the potential for cost efficiency improvement from mergers but concludes that the potential for cost efficiency improvement generally has not been realized. Studies comparing simple cost ratios, such as the operating cost to total assets ratio, typically found no substantial change in cost performance associated with bank mergers.[87] More sophisticated frontier cost function studies that estimate the efficiency effects of mergers by measuring the distance from the best-practice cost frontier and have found little or no improvement on average in cost efficiency.[88] For example, Berger and Humphrey (1992) found that merged banks experienced about a 5 percentage point improvement in cost efficiency relative to their peer group, but this improvement was not statistically significant.[89]

A determination that cost efficiency improved or worsened does not by itself necessarily imply that the firm has become more or less efficient overall, or become more or less profitable. A merger can increase profit efficiency without increasing market power. Akhavein et.al. (1997) posit a number of ways that a merger could increase the revenue derived from a given set of inputs at a given set of prices. They define revenue inefficiency as the failure to produce the highest value of output for a given set of input quantities and output prices. A firm may be revenue inefficient because it produces too few outputs for the given inputs (analogous to a cost inefficient firm that uses too many inputs to produce the given outputs). Alternatively, a firm may be revenue inefficient because it produces too little of a high-priced output and too much of a low-priced output, even if it is on the production-possibilities frontier (analogous to the cost inefficiency of a technically efficient firm that employs too much of a relatively high priced input).

While this evidence is interesting, the existence or non-existence of economies of large size is of secondary concern. The principal concern of this study is whether the merger review process as it is presently constituted gives proper consideration to efficiencies evidence, whatever it may be. If it does not or may not do so, the mandate of the study is to suggest ways in which the merger review process could be altered so as to take proper account of efficiencies arguments.

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[86] This is the literature cited in Kerton (1997).

[87] Rhoades (1986,1990), Srinivasin (1992), Srinivasin and Wall (1992), Linder and Crane (1992), Pilloff (1996).

[88] Berger and Humphrey (1992), Rhoades (1993), Peristiani (1995) and DeYoung (1996).

[89] In another paper Berger and Humphrey (1992a) note an apparent conflict between the results of both their study and other econometric studies and the consultant studies produced in connection with proposed bank mergers which forecast considerable cost savings from large bank mergers -- as much as 30 percent of the operating expenses of the acquired bank. In fact, the two bodies of results do not necessarily disagree substantively. Often it is merely a matter of using different denominators with the consultants expressing cost saving relative to the costs of the acquired bank and the econometric studies using the costs of the merged entity as a base.

Efficiencies in Competition Law

International Differences in the Treatment of Efficiencies in Competition Law

Competition policy is fundamentally (but not exclusively) about the pursuit of efficiency. Consequently, efficiency considerations enter into the enforcement of national competition laws in a number of different ways. Some of these are described briefly below.

Mergers

Efficiencies considerations enter the merger enforcement process in a variety of ways. In a number of countries (Canada, Australia, New Zealand, Britain, United States), there is either a statutory or an administrative provision for an efficiency exception or defence under which efficiencies evidence can either be used along with other evidence to determine whether a merger is anticompetitive or be used to defend an anticompetitive merger. In other jurisdictions, efficiencies considerations enter merger evaluation less directly. The ways in which efficiencies considerations can be incorporated in merger evaluation are discussed in detail below.

Horizontal Restraints

Many countries provide for some form of efficiencies defence or exception for horizontal restraints falling short of merger. New Zealand provides essentially the same defence that is available to the parties in merger cases. This is also true of Australia. Italy allows a limited efficiencies defence for horizontal agreements but not for mergers.

The European Community allows for the exemption of agreements which also bring about economic benefits, such as improving the production or distribution of goods or promoting technical or economic progress, from the prohibition of anticompetitive agreements. The benefits must outweigh the reduction in competition in order to qualify for an exemption. The exemption is not available to agreements which eliminate effective competition. This is defined to have occurred when market dominance is achieved. Arrangements involving price or quota fixing or market sharing are regarded as especially restrictive of competition and, as a consequence, unlikely to be outweighed by efficiency gains.

In Canada, the *Competition Act* provides the same efficiencies defence for (registered) specialization agreements as it does for mergers. The *Act* also provides a defence for R&D joint ventures involving a specific program of research which would not otherwise take place. Arrangements among competitors with respect to the exchange of statistics, defining product standards, the exchange of credit information, the definition of terminology, cooperation in research and development, restriction of advertising, package sizes and shapes use of metric measures and environmental protection measures are not criminal offences under the Act unless they have the effect of lessening competition unduly with respect to prices, output, markets or customers or channels of distribution. There is no defence in Canada for an agreement which lessens competition unduly in these dimensions.

In the United States, efficiencies play an important role in determining whether a horizontal agreement will be accorded *per se* or "rule of reason" treatment. When an agreement does not facilitate an efficiency-enhancing integration of economic activity and involves restraints such as market allocation, price-fixing and group boycotts by firms with market power, the *per se* rule is applied. Otherwise, a rule of reason approach is used. Where the rule of reason is the appropriate standard, an evaluation of efficiencies is important in determining whether an agreement is, on balance, procompetitive or anticompetitive and therefore illegal. Judicial decisions in the United States have recognized two broad categories of efficiency-enhancing restraints, those that reduce the cost of providing a product or increase its quality and those that are necessary for the product to be provided at all.

A necessary characteristic of an efficiency-enhancing restraint is that it involve some form of economic integration (such as a partnership agreement) among the participants that goes beyond the mere coordination of price or output and which facilitates the realization of the efficiencies claimed. Horizontal restraints such as specialization agreements and production joint ventures involve an integration of economic activity and are evaluated on a rule of reason basis. These restraints can be defended on the grounds that they are reasonably necessary to achieve an objective which is ultimately procompetitive. For example, an agreement that resulted in the development of new products or new markets could be regarded as procompetitive. These issues are examined in greater detail below.

Vertical Restraints

Efficiencies also play a role in the evaluation of non-price vertical restraints in some countries. Non-price vertical restraints include: (a) exclusive franchising; (b) exclusive dealing or requirements contracts; (c) tying or bundling. In the United States, for example, the imposition of territorial restraints on downstream intrabrand competition by an upstream supplier can be defended on the grounds that these restraints are an efficient means of promoting interbrand competition and that the benefits of increased interbrand competition more than offset the detrimental effects of reduced intrabrand competition. The same principle is applied to exclusive dealing. Tying or bundling is also assessed on a rule of reason basis unless significant power in the market for the tying good is shown. Even when they have significant power in the tying market, an affirmative defence in the form of a legitimate business justification has been available to defendants. Tying arrangements that ensure or enhance product quality, respond to consumer preferences or facilitate the introduction of a new product have been held to have a legitimate business justification.

Abuse of Dominance

Efficiencies may play a role in abuse of dominance provisions in competition statutes. In Canada, for example, the *Competition Act* specifically requires consideration of whether the exclusion of competitors from a market is a consequence of the superior competitive performance of the dominant firm. Dominant firms are not obliged to hold a pricing “umbrella” over less efficient rivals.

Whether exclusionary practices by dominant firms can be defended either on the basis that they are procompetitive on balance or that they increase total surplus (i.e. increase profits by more than they reduce consumers surplus) is another question. In some jurisdictions no defence of any kind is available. In the European Community, for example, there is simply no defence for exclusionary acts committed by a dominant firm (a firm with a market share in excess of 40-45 percent). More generally, it would probably not be a defence in any jurisdiction for a dominant firm to claim that its exclusionary practices (requirements contracts or exclusive dealing, for example) allowed it to realize economies of scale.

Nevertheless, efficiencies considerations are likely to become more prominent in the adjudication of abuse of dominance cases in the future. In the United States, an affirmative efficiencies (business justification) defence for tying arrangements may be available to defendants with shares of 30 percent or more in the market for the tying product. There have also been concerns raised regarding the efficiencies consequences of mandating access to dominant networks or standards.

The Efficiencies Defence for Mergers in Canada

Statutory Efficiencies Defence

Canada is unique in providing a statutory, affirmative efficiencies defence for mergers which have been found by the Competition Tribunal to lessen competition substantially. Section 96 of the *Competition Act* provides a defence for mergers that have been found to prevent or lessen competition substantially under Section 92. The defence reads as follows:

> **96.** (1) The Tribunal shall not make an order under section 92 if it finds that the merger or proposed merger in respect of which the application is made has brought about or is likely to bring about gains in efficiency that will be greater than, and will offset, the effects of any prevention or lessening of competition that will result or is likely to result from the merger or proposed merger and that the gains in efficiency would not likely be attained if the order were made.
>
> (2) In considering whether a merger or proposed merger is likely to bring about gains in efficiency described in subsection (1), the Tribunal shall consider whether such gains will result in
>
> (a) a significant increase in the real value of exports; or
>
> (b) a significant substitution of domestic products for imported products.
>
> (3) For the purposes of this section, the Tribunal shall not find that a merger or proposed merger has brought about or is likely to bring about gains in efficiency by reason only of a redistribution of income between two or more persons.

The Merger Enforcement Guidelines

The interpretation placed on Section 96 by the Competition Bureau is given in its *Merger Enforcement Guidelines (MEGS).* According to the *Guidelines*, Section 96(1) creates a "tradeoff framework" within which efficiency gains that are likely to be brought about in Canada are balanced against the anticompetitive effects that are likely to result from the merger. If it is satisfied that the gains in efficiency likely to be brought about by a proposed merger are greater than and will offset it anticompetitive effects, then the Competition Tribunal is obliged under Section 96 to decline to issue an order prohibiting or dissolving that merger.

The *Guidelines* define anticompetitive effects as:

> ...the part of the total loss incurred by buyers and sellers in Canada that is not merely a transfer from one party to another, but represents a loss to the economy as a whole, attributable to diversion of resources to lower valued uses. This loss is sometimes referred to as the deadweight loss to the Canadian economy. (p.45)

The definition of anticompetitive effects has been the subject of some dispute. Specifically, it has been argued that anticompetitive effects should be defined to include transfers of surplus in addition to lost surplus. This is discussed in connection with the Tribunal's interpretation of Section 96 below.

Interpreting the Guidelines

Eligible efficiencies are those that would not likely be realized if an order were made. Efficiency gains are ineligible for the defence under Section 96 if they would likely be realized even if the remedial order sought by the Director were granted. Alternative means of realizing efficiency gains include internal growth, an alternative merger that does not lessen competition substantially, a joint venture, a specialization agreement or a licensing, lease or other contractual agreement.

Alternatives to the merger must be grounded in industry practice rather than merely hypothetical. The consideration of alternative mergers is limited to those that have actually been proposed.

Efficiency gains must be real rather than pecuniary. A real efficiency gain is defined as a reduction in the opportunity cost of the resources required to produce a given level and quality of output. Opportunity cost may decline because fewer or lower quality resources or both are required to produce a given level and quality of output. Savings realized either by using bargaining leverage to reduce the price rather than the opportunity cost of resources used or by reducing government tax revenue are not eligible.

The *Guidelines* recognize two categories of efficiency gains. These are production efficiencies and dynamic efficiencies. Production efficiencies include:

(i) product, plant and multi-plant operating and fixed cost efficiencies;

(ii) savings in transaction costs resulting from the substitution of transactions within the merged entity for arm's-length transactions between the merging parties as well as from integration of new activities into the merged entity;

(iii) gains from trade on transactions within the merged entity (transfer of knowhow and management skills) that would not have occurred on an arm's-length basis.

Production efficiencies include economies of large batch size, economies of plant scale and scope and multiplant scale economies. The sources of these efficiencies include reduced changeover time, more specialized equipment, greater capacity utilization, reduced materials and spare parts inventories, reduced capital requirements and administrative and plant rationalization.

Although the Guidelines frequently use the terminology of a manufacturing business, they apply and have frequently been applied to distribution and service businesses. In distribution businesses, efficiencies are often derived from consolidation of warehouses and wholesale/retail outlets, consolidation of truck shipments, reduced cross-hauling, reduced inventories, consolidation of administrative functions such as payroll and training and billing, elimination of duplicate advertising and promotional expenditures, consolidation of sales forces and elimination of duplicate R&D efforts (for example for new proprietary stock control or billing systems).

Dynamic efficiencies are product and process innovations that either would not occur or would occur in a less timely manner in the absence of the merger. This could occur as a consequence of the elimination of duplication or potential duplication of R&D activities. It could involve the acquisition of a new technology which neither party to the merger could profitably purchase independently or under any cooperative arrangement short of merger. Efficiencies of this nature are said to be central to Schedule I bank mergers. Whether the Director treats efficiencies of this nature as a qualitative (as opposed to quantifiable) factor and whether the importance of new technologies acquired as a result of a merger for penetration or retention of foreign markets will be recognized at all is discussed further below.

The *Guidelines* interpret this phrase "greater than and offset" in Section 96 as requiring that quantifiable efficiency gains exceed (are greater than) quantifiable anticompetitive effects and that non-quantifiable efficiency gains offset non-quantifiable anticompetitive effects.

As stated above, the *Guidelines* define the anticompetitive effects of a merger to be the deadweight loss in Canadian consumer and producer surplus resulting from the restriction of output by the merged entity plus any non-quantifiable losses in quality, service, variety and innovation in Canada.[90]

A merger that lessens competition gives the merged entity the power to raise the price of its product offering. As a consequence of this price increase, some customers who used to buy the

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[90]The buyer and the seller in any transaction must expect to be better off with the transaction than they would be without it or they would not enter into it. The amount by which they are better off is called the gain from exchange and it can be broken down into consumer surplus (the gain realized by the buyer) and producer surplus (the gain realized by the seller).

product no longer do so. The loss in surplus on transactions that no longer occur is called a deadweight loss. Deadweight loss is the standard measure of the inefficiency of resource allocation resulting from the distortion of price signals in a market economy. It is estimated by economists and used to evaluate the efficiency consequences of distortions arising from taxes, tariffs, quotas and subsidies as well as from the private exercise of market power. Anticompetitive effects are defined to include those occurring in markets where the prevention or lessening of competition resulting from the merger has not been substantial.

Exports and Import Substitution

The *Guidelines* require that efficiency gains that are contingent on the merger and are realized in Canada be traded off against the deadweight loss in producer and consumer surplus that is likely to occur in Canada as a result of the merger. Deadweight losses occurring in foreign markets as a result of the exercise of monopoly or monopsony power by the merged entity do not count against the merger. It appears as if efficiencies realized in owned or affiliated establishments located abroad would not count in favour of the merger.

The interpretation of Section 96(2) in the *Guidelines* is that:

> ...this provision is simply considered to draw attention to the fact that, in calculating the merged entity's total output for the purpose of arriving at unit and other cost savings brought about by the merger, the output that will likely displace imports and any increased output that is sold abroad must be taken into account. (p.50)

The merged entity can be said to have become more efficient if, as a consequence of the merger, its costs have increased a smaller percentage than its output or if its costs have decreased by a smaller percentage than its output. The Guidelines interpret Section 92(2) as requiring only that, in making this calculation, all domestic output whether exported or not, should be counted. In the simplest terms, the Guidelines interpret Section 96(2) as requiring only that production for export be included in the denominator when pre- and post-merger unit costs are calculated. This is the same thing as crediting the merger with profits and quasi-rents (contribution to fixed overhead) on imports backed-out or additional exports attributable to the merger. Increases in exports and import substitution may also be regarded as a qualitative factor to the extent that they provide better evidence of an increase in the efficiency of domestic production. Note, however, that if the merged entity used its newfound ability to source domestically to lever concessions out of a specialized foreign supplier, Section 96(3) would rule out counting this in its favour.

Transfers of surplus within Canada are assumed by the Director to cancel each other out. No distinction is made between Canadians as customers and Canadians as shareholders. The Tribunal has questioned this interpretation of Section 96 and the Director may ultimately abandon it in favour of a "customers must not lose" approach. The *Guidelines* also make no explicit distinction between foreign and domestically-owned firms operating in Canada. A merger involving one or more foreign-owned firms operating in Canada is presently treated no differently under the *Guidelines* than a merger between two Canadian-owned firms. The Tribunal is apparently uncomfortable with this also.

To summarize, the *Merger Enforcement Guidelines* imply that the Director will normally not challenge a merger that results in a net benefit to the economy. The merger need not be beneficial to everyone. Some customers may be worse off. What matters according to the *Guidelines* is that customers and shareholders in aggregate are better off as a result of the merger, that is, shareholders gain more than customers lose. In the case of banking, this implies that the Director would not challenge a merger that reduced the number of bank branches in a small community to two or even to one even though this meant longer travel distances, increased waiting times and perhaps higher charges for local residents if the closing of redundant branches yielded commensurate savings to the merged entity. The Tribunal has indicated that it would not necessarily see matters this way. This is discussed below.

The Competition Tribunal on Section 96

Although its decision in *Hillsdown* did not turn on efficiencies, the Tribunal nevertheless took issue with the definition of the anticompetitive effect of a merger employed by the Director (and in the *Merger enforcement Guidelines*). The Tribunal argued that the anticompetitive effect should include any redistribution of surplus resulting from the exercise of market power as well as the deadweight loss in surplus. In essence, the Tribunal rejected the aggregate net benefit interpretation in the MEGS in favour of an approach which gives greater weight, if not primacy, to losses suffered by customers.

The Tribunal stated there was nothing in S. 96 to imply that "the effects of any prevention or lessening of competition" should be interpreted as the deadweight loss. The Tribunal went on to argue that the purpose of the Competition Act, as stated in S.1.1, is to provide consumers with competitive prices as well as to promote the efficiency and adaptability of the Canadian economy. According to the Tribunal, there is no jurisprudence implying that S.1.1 must be read so as to give precedence to efficiency over competitive prices for consumers.

The Tribunal acknowledged the argument that defining the anticompetitive effect to include transfers of surplus could result in the disallowance of a significant number of efficiency-enhancing mergers. It responded by suggesting that efficiency gains be given more weight where detrimental effects (transfer plus deadweight loss) are "not positively certain to follow" from a substantial lessening. The Tribunal's proposal is as follows:

> Certainly, one interpretation which is open on the basis of the wording of Section 96(1) is to weigh any alleged efficiency gains against the degree of likelihood that detrimental effects (both wealth transfers and allocative inefficiency) will arise from the substantial lessening of competition. That is, in those cases where such effects are likely but not positively certain to follow, one could give more weight to efficiency gains than where the reverse is true. The likely detrimental effects of a merger may on some occasions be moderate in extent, in others they may be quite extreme. It is not unreasonable to expect that a balancing of the alleged efficiency gains could be assessed by references thereto.

> To the extent that efficiency gains would be likely to lead to lower prices for consumers this would likely be determinative.[91]

The Tribunal's reasoning may be taken to imply any one of three standards for the efficiencies defence. One is that efficiencies must exceed the loss in consumers surplus resulting from the merger. The second is that all efficiency gains must be passed on to consumers. The third is that the merger must not result in any reduction in consumers surplus.

All three standards suggested by the Tribunal are incompatible with an aggregate net benefit to the economy test. A requirement that *all* efficiencies be passed on to consumers could only be met if there were no market problem in the first place.[92] A requirement that customers suffer no significant price increases (or service degradation) as a result of the merger would rule out mergers which increased shareholder wealth by more than they reduced customer wealth.[93]

The attraction of the "price shall not rise" approach to the Tribunal may be related to its concern with the international distribution of changes in surplus resulting from mergers. A merger may be welfare-increasing from a global perspective but not from a strictly Canadian perspective. For example, a merger of two Canadian affiliates of foreign firms may increase the profits of these firms by more than it reduces (Canadian) consumers surplus and thus be welfare-increasing from a global perspective. Since these increased profits accrue to foreign parents, however, Canada would experience a net loss in surplus. This would not occur if mergers affecting Canadian customers adversely were prohibited. Of course, aggregate wealth-increasing mergers between Canadian firms would also be ruled out. Thus, whatever merit the Tribunal's approach may have in general, it is less attractive in the financial services sector and especially in Schedule I banking where domestic ownership dominates. In this case, the Tribunal's approach amounts to prohibiting mergers in which Canadians lose one dollar as customers but gain two dollars as shareholders.

Efficiencies in Financial Service Sector Mergers: Likely Competition Issues

According to their submissions, the Schedule I banks anticipate that they will realize efficiency gains from domestic mergers. These efficiency gains would help them to retain or penetrate foreign markets as well as reducing costs and improving service quality in domestic markets. The most recent empirical evidence on economies of scale and scope in banking supports arguments that efficiency gains may be realized even in mergers among banks which are large by U.S. standards ($25 billion in assets) although not necessarily by Canadian standards.

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[91] Canada (Director of Investigation and Research) v. Hillsdown Holdings Canada (1992) 41 C.P.R. (3d) 343.

[92] It is for this reason that Pitofsky (1992, p.207) has called the requirement that all efficiency gains be passed on a "killer qualification."

[93] It would be interesting to see how the Tribunal would deal with a situation in which customers had to drive further and wait longer to do their banking as a result of a merger-induced branch rationalization if it were to employ this standard.

A possible scenario could involve a merger between two Schedule I banks each with large overlapping domestic branch networks. Suppose the result is an increase in domestic market power with the potentially adverse consequences for price and service that this implies. Suppose there are also efficiency gains. There are apparently significant fixed costs in adopting new technology. As a consequence, the merged entity finds it profitable to adopt new technology that neither of the parties would have found profitable to adopt had they remained independent or had they attempted to cooperate in some way. This new technology reduces the cost of serving domestic markets and service innovations are also made possible. Suppose, nevertheless, that the net effect of the merger on domestic competition is negative, that is, despite the availability of new or better financial services, Canadian customers are worse off. This new technology also helps the merged entity to retain some foreign markets and to increase penetration of others. The margin on additional and retained foreign sales also contributes to the coverage of the fixed cost of adopting the technology.

There are two questions here. The first is how this merger should be evaluated. The second is how it would be evaluated. With respect to how the merger should be evaluated, one approach is to evaluate the costs and benefits to Canada. Taking this perspective and assuming that the firms involved are domestically owned, the costs of the merger are: (1) the loss in domestic consumers surplus due to the diminution of competition; and (2) the cost of the new technology. The benefit of the merger is the increase in profit realized by the merged entity due to: (a) the diminution of competition in the domestic market; (b) the cost savings and quality improvements in the domestic market made possible by the new technology; (c) the loss in profit avoided by retaining foreign markets that would otherwise have been lost; and (d) the increased profit (contribution or quasi-rent) resulting from the increased penetration of foreign markets that would otherwise not have occurred. While this approach is strictly efficiency-oriented, it does give credit to the merged entity for increasing, or avoiding the loss of, sales in foreign markets. In this sense it takes into account some of the competitiveness or public interest arguments entertained by competition authorities in other jurisdictions.

The merger would probably not be evaluated as described above under the MEGS, at least not if the Bureau persists in its past interpretation of Section 96(2). As the MEGS stand, the profits gained or losses avoided in foreign markets as a result of the merger would not count in its favour. According to the Bureau's domestic total welfare view, the cost of the merger would be: (1) the loss in domestic consumers surplus due to the diminution of domestic competition; and (2) the cost of the new technology. The benefit of the merger would be the increase in profit realized by the merged entity due to: (a) the diminution of competition in the domestic market; and (b) the cost savings and quality improvements in the domestic market made possible by the new technology. The current MEGS would find the merger acceptable if increased profits due either to market power or efficiency gains exceeded the loss in consumers' surplus. Washing out the transfer, the criterion under the current MEGS is that the cost savings in the domestic market exceed the deadweight loss in domestic consumers surplus resulting from the merger. This begs the question of how to allocate the cost of the new technology which is applied jointly in the domestic and in foreign markets. This may not matter. Allocation of the entire cost of the technology to the domestic market may still result in domestic cost savings sufficient to offset the deadweight loss in domestic customer surplus. Under other circumstances, the allocation of the cost of the new technology will matter. That is, the cost saving in the domestic market will

exceed the deadweight loss only if part of the cost of the technology is allocated to foreign markets. Put another way, unless some credit is given for profits on increased foreign sales or on foreign sales which would otherwise have been lost, the merger would fail to satisfy the S.96 requirement. It is not clear what the Bureau would do under these circumstances.

Of course, if the Tribunal interprets S.96 as it suggested it might in *Hillsdown*, then Section 96 would never be satisfied under the merger scenario described above. Under the Tribunal's proposed interpretation, there would never be any trade-off between lost domestic customer surplus and cost savings no matter where the cost savings are realized. Section 96 would not apply as long as domestic customers experience any adverse effects such as poorer service, lower interest rates on deposits, higher interest rates on loans or higher services charges. If the Tribunal carries through with its stated interpretation of S.96, there would be no explicit recognition of the role of the merger in increasing or avoiding the loss of foreign sales. As a consequence, the cost saving experienced by the merged entity in the domestic market would have to be large enough that, even though it has fewer competitors, it does not reduce the rates it pays on deposits or increase the rates it charges for loans or services in the domestic market. While there is no direct credit for them, foreign sales still matter implicitly. They cover part of the cost of the new technology. Without the new technology, there would have been no prospect of maintaining prices and service quality in the domestic market after the merger and thus no prospect that the merger would be allowed.

In sum, exports, foreign sales and import substitution should not be valued for their own sake and merger review processes that do so are misguided. Nevertheless, increases in profits in foreign markets made possible by a merger are a benefit to the domestic economy and, in principle, at least, this should be taken into account in merger review. Neither the current MEGS nor the Tribunal's interpretation of Section 96 allow for this. As a consequence, they invite parallel, industrial policy-style review with all the attendant anticompetitive consequences historically associated with this form of intervention.

Efficiencies, Competitiveness and the Public Interest

International Competitiveness

It is frequently argued that merger policy should take international competitiveness into account. There are many versions of this argument. Some are consistent with the current application of competition law and some are not. One widely accepted approach to competitiveness is to define it in terms of productivity levels and productivity growth. It is productivity and productivity growth that are the sources of high and rising national per capita income which, in turn, is the ultimate measure of national competitiveness.[94] The *Competition Act* as it is presently interpreted and enforced encourages competitiveness in two ways. First, competitive markets themselves facilitate productivity growth. Second, the Act allows for the possibility of mergers and specialization agreements that increase productivity even though they may also reduce

[94] D.G. McFetridge, "Competitiveness: Concepts and Measures" (Occasional Paper Number 5, Industry Canada, 1995).

competition. In principle, the Director would not challenge any merger that is of net benefit to the economy. If competitiveness is defined in terms of GDP per capita, the Director would not presently challenge any merger that increases competitiveness. As stated above, the Competition Tribunal may view matters differently.

Other definitions of competitiveness focus strictly on world market shares. One is the national champions argument and its variants. Advocates of this approach argue that, in order to export successfully, a domestic firm must have a "secure" (read protected and monopolized) domestic market. It can then cover front end costs from domestic revenues and possibly also cross-subsidize exports. This argument has less currency than it has in the past. There are good reasons for this. Sheltered national champions often did not venture far into export markets and when they did, being unprepared for serious competition, they failed. Second, even when this policy "worked" in the sense of generating exports, like any export subsidy, it did not benefit the national economy and thus did not increase competitiveness. Competition policy has not been receptive to arguments favouring the creation of national champions with domestic market power and this is quite compatible with the pursuit of competitiveness properly defined.

Efficiency Gains and the Public Interest

A long line of Canadian competition cases have defined the public interest as being in the promotion of free competition. The *Competition Act* recognizes that competition may occasionally have to be sacrificed in order to achieve efficiencies. These efficiencies may result in increased exports or import substitution but they need not do so. In its interpretation and enforcement, the *Competition Act* is neutral insofar as all merger consequences other than competitive effects and efficiency gains are concerned. Domestic ownership and employment creation and other industrial policy goals are not factors in merger cases. This is also true of the United States. It is not true, however, of Europe. In Europe, industrial policy concerns continue to influence merger decisions. This is discussed in greater detail below.

Public Interest Tests in Other Countries

Some national competition statutes or merger guidelines suggest that the "public interest" will be taken into account when assessing mergers. The public interest may be defined to include more than the preservation and enhancement of competition and the achievement of static and dynamic efficiency gains. For example, New Zealand's *Commerce Act* of 1975 included an explicit list of public benefits that should be taken into account when assessing the net consequences of either a merger or horizontal restraints. Public benefits included export activity, employment, value adding activity and earning foreign exchange. This list was omitted from the 1986 act. While the list is thought by some to continue to have precedential value, Commerce Commission guidelines state that increases in employment and export propensities and in economic activity in depressed regions are generally not considered to be public benefits.

Other countries, including Australia, Germany and the United Kingdom, have public interest provisions in their competition statutes. In Australia, anticompetitive conduct (including mergers) can be exempted from the *Trade Practices Act* of 1974 if the Trade Practices

Commission finds that there are countervailing public benefits. In Germany, the *Act Against Restraints of Competition* permits the exemption of a merger based on either its overall economic advantages or on an overriding public interest. Between 1973 and 1991 there were six exemptions granted for energy, employment, technology and competitiveness reasons.[95]

In the United Kingdom, restrictive agreements and mergers can be referred to the Restrictive Practices Court and the Monopolies and Mergers Commission respectively for an evaluation of whether they are contrary to the public interest. In making its determination, the Monopolies and Mergers Commission (MMC) is directed by the *Fair Trading Act* of 1973 to take the effect of a merger or agreement on the distribution of industry and employment and on domestic imports and exports as well as its effects on both competition and static and dynamic efficiency gains into account. A ministerial statement in 1984 directed that competition concerns should be paramount. Nevertheless, balance of payments, international competitiveness and employment arguments continue to be entertained. Of forty MMC merger decisions rendered between 1984 and 1990, balance of payments improvements and employment increases were each cited as benefits in five cases.[96]

International competitiveness considerations can be found in several MMC decisions. In the 1987 British Airways decision, the Commission cited one of the benefits of the merger of British Airways and British Caledonian Group as strengthening the competitive position of British Airways against the American "megacarriers."[97] Similarly, one of the Commission's reasons for approving the acquisition of submarine cable producer STC Limited by Alcatel in 1994 was that the merger would preserve STC's presence in the United Kingdom as a significant exporter and employer at the leading edge of telecommunications technology.[98]

The MMC appears to have taken public interest considerations well beyond employment and export promotion. An example is the 1991 decision of the Mergers and Monopolies Commission decision regarding the merger of two British rendering firms. The Commission defined the public interest as requiring: first and most importantly, that rendering services be effective and reliable; second, that rendering activity should not unduly pollute the environment and; third, that the industry should be economically efficient. The Commission concluded that, notwithstanding its dominance of the market, the merged entity satisfied these criteria.[99]

Conclusion

It has been suggested that bank mergers be subject to a public interest test which goes beyond competition, efficiency and prudential concerns. Merger assessment with respect to industrial policy issues would have to be carried on outside the *Competition Act*, perhaps by the Minister of Finance. Banking would then be one of a very few industries in the Canadian economy on which such requirements would be imposed. Whether this is warranted is an issue for others to address.

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[95] Crampton (1992).
[96] Weir (1993), p.951.
[97] Finbow and Parr (1995), p.252.
[98] Finbow and Parr (1995), p.253.
[99] The Monopolies and Mergers Commission, *Animal Waste* (1985) pp. 88-92.

What is of concern in this study is whether the merger review process as it stands will give appropriate weight to efficiencies arguments themselves. There is some doubt that it will.

Table VII.1
Cost per Dollar of Assets and Asset Size in U.S. Banking

Bank Size	Number of Banks	Total Cost: Gross Total Assets
0-$50M	2218	0.0482
$50M - $100M	1794	0.0473
$100M - $300M	1344	0.0466
$300M-$IB	392	0.0453
$1 B-$10B	171	0.0436
> $10B	30	0.0427
Total	5949	0.0443

Source: Berger and Mester (1997)

VIII. Vertical Restrictions

Tying and Related Practices

The Issues

The issues raised by the Task Force with respect to tying are as follows:

1. Is Canadian competition law presently sufficient to prevent welfare-reducing tying?
2. Would increases in concentration in the financial services industry result in more tying?
   - Would Schedule I banks be more likely to engage in tying if mergers among them were allowed?
3. Would an expansion of powers of banks or other suppliers of financial services result in more welfare-reducing tying?
   - Would banks tie insurance and auto leasing to lending or to the supply of other services if they were permitted to enter insurance and leasing markets?
4. Is tying a potentially more serious problem in the financial services sector than in other industries?

Defining Tying

Tying occurs when the sale of one product, the tying product, is conditional on the agreement of the customer to purchase another product, the tied product from the same seller. Under a tying contract, a purchaser of one product must buy all their requirements for another product from the same seller. Closely related to tying is bundling. Under a bundling contract, a purchaser of one product must buy a fixed amount of another product. Under a pure bundling arrangement, two or more products are sold in a package and only in a package. Under a mixed bundling arrangement, products are sold both individually and in a package. With mixed bundling, the price of the package must be less than the stand alone prices of its components or there would be no incentive to buy the package. This price difference is known as an inducement. Single products can also be bundled. This takes the form of a minimum purchase requirement and is called single product forcing.

Tying in Perspective

Multi-product firms may engage in forms of behaviour other than tying that raise concerns in some quarters. Concerns have been raised, for example, regarding predatory cross-subsidization by banks in the event that they are allowed into markets for other financial services such as insurance and auto leasing.

It is important to understand that multi-product firms generally do not maintain equal mark-ups on all their product lines. Mark-ups are generally lower on products with higher elasticities of demand. These are products with more and/or closer substitutes. In essence, mark-ups are lower where there is more competition. This is not cross-subsidization. Nor is it predatory.

Cross-subsidization is rigorously defined in the literature on regulation. A product line is being cross-subsidized if it is sold at a price that is less than its average incremental cost. Incremental cost includes product-specific fixed costs (i.e. set-up costs) plus variable costs. A product line is the *source* of a cross-subsidy to other product lines if it is sold at a price in excess of its stand-alone average cost. If there is competition, sustained sale at a price in excess of stand-alone average cost and thus cross-subsidization is not possible.

There is no case in the regulatory literature for an arbitrary (pro rata for example) assignment of a portion of joint costs to each product line. As long as a product line covers its incremental costs and makes some contribution to joint costs it is profitable and not predatory.

A product line may be sold at a price that does not cover its average incremental cost and yet not be cross-subsidized if it is complementary to other product lines sold by the firm involved. This can occur if the presence of one product line increases the demand for other product lines offered by the same firm. If the additional revenue earned on other product lines plus the revenue derived from the product line in question is sufficient to cover its incremental costs, there is no cross-subsidy.

If the sum of revenues from a product line and increased revenues on complementary product lines is insufficient to cover the incremental cost of that product line, a cross-subsidy exists. This could be predatory if the intent is to recoup current losses from selling at a price below average incremental cost by selling at a higher price once competitors have been driven from the market. The key question is then whether the alleged predator is likely to acquire sufficient market power to recoup the profit sacrificed during the period of cross-subsidization. The Competition Bureau regards predatory cross-subsidization (as opposed to vigorous price competition) as being extremely rare.[100]

Concerns have also been raised about "unfair" competition resulting from the use by Schedule I banks or others of information, skills or reputation acquired in one market in order to seek business in another. This is another example of the exploitation of economies of scope and is both efficient and pro-competitive. Schedule I banks are not the only firms in the market with potential economies of scope to exploit. Some competitive advantages may be artificial in that they reflect tax or other regulatory advantages. There may be merit in eliminating or offsetting these advantages in some way (level the playing field). Other advantages may be a consequence of past but not present regulatory or tax policies. While these advantages may have been unfairly acquired, they are nevertheless real and it makes little sense to continue to limit their exploitation.

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[100] According to the Competition Bureau's 1996 submission to the Department of Finance, (n.8), of 550 complaints received by the Bureau between 1980 and 1990, only three resulted in the laying of charges. Of these, one resulted in an acquittal, one resulted in withdrawal of charges and one has not been decided.

Banks may also be perceived to have an unfair competitive advantage in other markets because as sources of credit they may have an "undue" influence over their customers. The Competition Bureau points out that even collectively banks are not unique as sources of credit. The issue here is more one of education of consumers to the full range of market alternatives available to them so that they understand the possibility of maintaining relationships with a variety of financial services suppliers.[101]

The Economics of Tying

Tying and bundling occur routinely in situations in which the exploitation and/or extension of market power by the seller is not an issue. Shoes come with laces. Stereo systems include both an amplifier and speakers. Cars come with tires, batteries and doors. Auto insurance includes collision, theft and liability coverage. Ties of this nature generally reflect either production or distribution cost savings in producing or selling a package rather than its individual components or customer search and transaction cost savings from buying a package rather than its individual components. Ties involving after-markets for parts and service can protect the integrity and the brand name of original equipment.[102]

Tying and bundling also occur in situations in which the seller has market power in the tying product or in both the tying and tied product and is attempting to exploit it more effectively but not to extend it. In this case, tying is a means of engaging in price discrimination, that is, of separating customers in terms of their willingness to pay and charging them accordingly. A well-known example of tying for the purpose of price discrimination involves the tying of complementary products where the demand for the tied product (say, paper) reflects the intensity of use of the tying product (say, a copying machine). The tied product is marked up with the result that more intensive users of the tied product pay more for it on a lifetime basis. In this case, tying is simply a substitute for metering with running royalties or some other form of two part pricing. If this form of tying were illegal, sellers would have to revert to some other form of two part (but probably less efficient) pricing. If two part pricing in any form were banned then the only alternative would be to raise the price of original equipment. Intensive users would benefit but less intensive users would probably be excluded from the market.

The classic bundling situation occurs where the valuations that potential customers place on two products are negatively correlated. That is, customers placing a high valuation on product A place a low valuation on product B and vice versa. A monopolist who could tell which customer was which would charge the high valued users of each product high prices and the low valued users low prices. If the seller cannot tell which customer is which, A and B must be sold at their simple monopoly prices. These prices have the disadvantage of excluding low valued customers from the market while failing to extract the maximum amount the high valued users are willing

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[101] Preliminary Submission of the Director of Investigation and Research to the Department of Finance, re The 1997 Review of Financial Institutions Legislation, January, 1996, ¶.110.

[102] Equipment which malfunctions due to poor servicing hurts the user but it also hurts the manufacturer's reputation and future sales (finger pointing). The user does not take this damage to the manufacturer's reputation into account when choosing a maintenance package. With a tie, both the user's interest and the manufacturer's interest in properly functioning equipment are taken into account.

to pay. This is where bundling comes in. Customer evaluations of a bundle containing both A and B will be more similar than were their individual evaluations of A and B. A simple monopoly price for the bundle will be more profitable in that it allows the extraction of more surplus from the high valued customers while excluding fewer low valued customers.

There are many ways tying and bundling can be used to price discriminate. There are several crucial points that must be made in this connection. First, the prohibition of tying and bundling does not eliminate the ability of sellers to engage in price discrimination. It simply forces sellers to discriminate by other means. This may involve some form of multi-part pricing or, in some cases, vertical integration. These may be less efficient and less satisfactory from both the customer's and the seller's point of view. Second, although price discrimination pre-supposes an identifiable demand for the product in question and some discretion over price, it is common in industries with large numbers of competitors in which market power is not generally perceived to be a problem. Third, it needn't and in fact generally doesn't imply any intent to extend market power nor does it generally have the effect of extending market power. It may even increase competition.[103] Fourth, price discrimination itself has ambiguous effects on welfare. In may increase or decrease surplus. That is, it allows extraction of additional surplus from high valued customers but it can also be a means of keeping customers with less willingness to pay in the market (think of seniors rates). Fifth, price discrimination is a means of covering fixed costs while continuing to supply customers willing to pay incremental cost. It is frequently argued that the so-called new economy is characterized by front-end innovation costs. For this reason, tying, bundling and multipart pricing will be common features of competition in the new economy. Sixth, with the exception of section 50(1)(a) which prohibits discrimination between competing buyers of like quantities, price discrimination is not against the law in Canada.

Tying and bundling may be used to foreclose competition and extend monopoly to another market. This is called leverage in that monopoly power in one market is used as a lever to obtain monopoly power in another. This theory has been the subject of some well-deserved criticism but retains some currency. The essence of the criticism of the leverage theory is that a single monopoly can yield only one stream of monopoly profits not two. Suppose product A is sold by a monopolist and product B is sold in a competitive market. If the most a customer will pay for product A is V_A then the A monopolist cannot force this customer to pay V_A for product A and also to purchase his requirements for product B from him at a price in excess of the competitive price of B. The customer will simply cease to buy product A and will continue to buy B from others at the competitive price.

It is not seriously disputed that, if purchasers of the tying good are paying a price equal to their full evaluation of it and prices charged by competing sellers of the tied good are given, there is no

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[103]This issue is much discussed. Competition often takes the form of confidential discounts off posted prices. Secret discounts and rebates are a means of cheating on cartel agreements and may lead to their collapse. Most Favoured Nation clauses in contracts have been opposed by competition authorities because they are thought to help stabilize cartels by ruling out discriminatory price cutting by cartel members. On the other hand, it used to be argued that the ability to discriminate made it less costly to deter entry. Prices could be reduced in the vicinity of the entrant rather than in the "entire" market. The Competition Tribunal has recently recognized, however, that "competing where there is competition" is not exclusionary behaviour.

additional profit in tying.[104] The rehabilitation of the leverage theory takes the form of demonstrations that, under some circumstances, tying can disadvantage competing suppliers of the tied good thus giving the monopolist in the market for the *tying good* an enduring advantage in the market for the *tied good* (hence the term leverage). It is not just any old tie that will do this. First, there must be a credible commitment to the tie. That means either that it is not readily reversible due to a technical lock-in (for example, shared files between Microsoft Explorer and Windows 95) or that it is profitable on its own as a means of price discrimination. Second, the tie must somehow disadvantage competitors in the tied good market. This disadvantage may be the result of higher costs due either to diseconomies of smaller scale production or to slower movement down the experience curve. Competitors in the tied good market may also be disadvantaged as a result of network effects (if, for example, computers using Netscape could not communicate with computers using Explorer). Whether the conditions required for successful leverage occur commonly is an open question.

Tying in the Competition Act

The relevant part of Section 77 of the *Competition Act* reads as follows:

> "tied selling" means
>
> (a) any practice whereby a supplier of a product, as a condition of supplying the product (the "tying" product) to a customer, requires that customer to
>
> (i) acquire any other product from the supplier or the supplier's nominee, or
>
> (ii) refrain from using or distributing, in conjunction with the tying product, another product that is not of a brand or manufacture designated by the supplier or the nominee, and
>
> (b) any practice whereby a supplier of a product induces a customer to meet a condition set out in subparagraph (a)(i) or (ii) by offering to supply the tying product to the customer on more favourable terms or conditions if the customer agrees to meet the condition set out in either of those subparagraphs.
>
> (2) Where, on application by the Director, the Tribunal finds that exclusive dealing or tied selling, because it is engaged in by a major supplier of a product in a market or because it is widespread in a market, is likely to

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[104] Slade (1996) demonstrates that what she calls "weak form" leveraging is profitable. With weak form leveraging the tying monopolist does not foreclose the market for the tied good. Tying is used instead to extract additional surplus from buyers of the tying good. In the terms of the example above, the customer's evaluation of A is V_A but the A monopolist is charging a simple monopoly price P_A which leaves this customer with consumers surplus S_A. Under these circumstances, the customer will accept a tie and buy B from the A monopolist at a price in excess of the competitive price of B as long as the additional amount he pays for B (actually the surplus he loses on B) is less than S_A. It remains the case that the A monopolist cannot extract any more than V_A from his customer. This point was made by Burstein (1960).

(a) impede entry into or expansion of a firm in the market,

(b) impede introduction of a product into or expansion of sales of a product in the market,

or

(c) have any other exclusionary effect in the market,

with the result that competition is or is likely to be lessened substantially, the Tribunal may make an order directed to all or any of the suppliers against whom an order is sought prohibiting them from continuing to engage in that exclusive dealing or tied selling and containing any other requirement that, in its opinion, is necessary to overcome the effects thereof in the market or to restore or stimulate competition in the market.

(3) Where, on application by the Director, the Tribunal finds that market restriction, because it is engaged in by a major supplier of a product or because it is widespread in relation to a product, is likely to substantially lessen competition in relation to the product, the Tribunal may make an order directed to all or any of the suppliers against whom an order is sought prohibiting them from continuing to engage in market restriction and containing any other requirement that, in its opinion, is necessary to restore or stimulate competition in relation to the product.

(4) The Tribunal shall not make an order under this section where, in its opinion,

(a) exclusive dealing or market restriction is or will be engaged in only for a reasonable period of time to facilitate entry of a new supplier of a product into a market or of a new product into a market,

(b) tied selling that is engaged in is reasonable having regard to the technological relationship between or among the products to which it applies, or

(c) tied selling that is engaged in by a person in the business of lending money is for the purpose of better securing loans made by that person and is reasonably necessary for that purpose,

and no order made under this section applies in respect of exclusive dealing, market restriction or tied selling between or among companies, partnerships and sole proprietorships that are affiliated.

Ties are defined in the *Competition Act* to include both situations in which a customer is required to purchase the tied good in order to obtain the tying good and situations in which the a customer is induced by better terms to purchase the tied good from the seller of the tying good. The situation in which a customer is required rather than induced to purchase the tied good from the seller of the tying good is sometimes referred to as an abusive or coercive tie. As the discussion below will indicate, this distinction is somewhat contrived. The concern of the *Competition Act*

is with the foreclosure of competition in the market for the tied good by either coercive ties or by induced ties that are not cost-justified.

Tying in the Competition Bureau's Submission to the Task Force

In its submission to the Task Force, the Competition Bureau repeats its long-held view that tying can be pro-competitive or anti-competitive. As a consequence, *per se* prohibition ("an outright ban") is unwarranted. Tying is anti-competitive if it forecloses a market to competitors or potential competitors. It is pro-competitive if it facilitates the realization of economies of scope or saves transaction costs. The Bureau gives the example of economies of scope in checking credit-worthiness. Once credit worthiness has been established, say in connection with a mortgage transaction, it might not need to be established again in connection with a consumer loan or other transaction. The price charged on the second transaction is less given that the first has occurred. There is no tie here but there is an inducement to buy the second (or third) product from the seller of the first.

Economies of scope would also be realized if banks were to make use of their client lists or deposit records to market insurance or other products (cross-marketing). In this case there needn't be either a tie or an inducement and Sections 77 and 79 would not apply. Banks would simply be using their own records to target their marketing more effectively. This is not uncommon. Every three months my car insurance company informs me how good its home insurance is. If there is a privacy issue, it can be solved by contract or, if absolutely necessary, privacy legislation. A bank could also offer insurance at a discount unconditionally but with the full recognition that customers attracted by favourable insurance premiums (or favourable terms on any important financial service) might also divert some of their other (higher margin) business to that bank. This is, of course, what supermarkets do and it would not be covered by Section 77.[105] If, however, a bank offered insurance at a discount to its depositors on the condition that they remained depositors on some scale, or my car insurance company offered me a discount on a car insurance-home insurance package, this would be an inducement and Section 77 would apply. The implication of its submission is that the Bureau would have no problem with any cost-justified inducement and would indeed be loathe to see the ability of financial sector firms to offer such inducements foreclosed in any way. The Bureau may view cost justification as a necessary for the defence for an inducement. Further discussion of this issue is required.

The Bureau notes that tying is a reviewable practice under Sections 77 and 79 of the Competition Act. It does not address the question of whether this remedy is effective or whether additional protection such as exists in the Bank Holding Company Act in the United States is required.[106] Nor does it address the issue of private actions or of the award of damages. Many of the tying cases brought in the United States are private actions.

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[105]It might be covered under section 50(1)(c) if the discounted product was priced below cost and this resulted in the elimination of a competitor.

[106]The anti-tying provisions of the Bank Holding Company Act are described later in Section VIII.

The Bureau recognizes that part of the perceived problem with tying is not with competition but with consumer protection. Consumers can be misled with regard to price or product quality or conditions of sale in the most competitive of markets. As White (1995, 1996) points out, banks and other lenders, insurance companies and car rental agencies are in the unique position of being required to refuse service to some customers. This may create a perception of coercion among some customers and it puts a premium on proper disclosure.[107] Whether existing consumer protection laws are sufficient in this regard is a question to be addressed by others.

The Bureau neglects to mention one of the most common motives for tying. It is not alone in this regard. Tying is generally not about market foreclosure. Firms involved in tying typically have very small shares of the market for the tied good and have no hope of monopolizing that good. The conditions for successful foreclosure are very difficult to satisfy. Tying is generally about price discrimination. It is ubiquitous. It is common in industries with large numbers of competitors as well as industries with small numbers of competitors. The welfare consequences of tying are ambiguous. It can be welfare-improving quite independently of any economies of scope that might be involved. It can be welfare-reducing even if it does not foreclose any markets. Whether a particular tying or bundling arrangement is likely to be welfare-increasing or welfare-reducing is very difficult to determine in most cases.

There is absolutely no case for a *per se* prohibition of tying or bundling arrangements. The Bureau makes this point. Most antitrust scholars argue for a rule of reason approach. Section 77 takes this approach. U.S. jurisprudence is evolving steadily in this direction. Even the rule of reason approach as it is presently constituted is probably too restrictive of tying arrangements. Most tying is simply inconsistent with a market foreclosure motive. Much rule of reason analysis equates injury to competitors with injury to competition. If it were to focus on price discrimination as it should, it would be inconclusive with respect to welfare consequences and the practice would be subject to challenge even less frequently than it now is.

The Concept of Abusive Tying

In June 1997, the Bank Act was amended to prohibit federally chartered banks from imposing undue pressure on a customer to obtain a product or service from that bank or its nominee or affiliates as a condition of obtaining a loan. This is referred to in some quarters as a coercive or abusive tie. It is distinguished from inducing a customer to obtain a second product from the bank by offering more favourable terms on the loan and from inducing the customer to obtain a loan by offering more favourable terms on another product supplied by the bank. This provision is not yet in force.

This provision differs from Section 77 of the Competition Act in a number of ways. Two of the most important are: (1) it does not require that a tie have anti-competitive consequences; and (2) it permits induced ties. Musgrove (1997) asks how these two tying provisions would relate to

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[107]Customers that are not credit worthy may also use the antitrust laws strategically in an attempt to force banks or other lenders to make loans to them.

each other. He raises the question of whether Section 77 would continue to apply to banks once the anti-tying provision of the Bank Act is proclaimed.

We are all against abuse and coercion. The concept of a coercive tie is, however, somewhat vacuous. What is the alternative to the tie? As a form of price discrimination, tying is favourable to some customers and unfavourable (coercive?) to others. On balance, it may increase participation in the market (allow transactions to occur that would not occur without the tie) or it may reduce participation. The Bank Act apparently defines situations in which individuals are forced to buy a package that they would not voluntarily accept as an abusive tie. There is a serious misunderstanding here. The alternative to the tie is generally not to price both goods at marginal cost. Prohibition of tying does not eliminate the seller's pricing discretion. Pricing discretion still exists and it will continue to be exercised in other ways. In the absence of the tie, the tying good is likely be priced at the simple monopoly price or as close to it as is attainable. With the tie, the profit-maximizing price of the tying good is lower but the price of the tied good is higher. The tied and tying good together may be either more expensive or less expensive than without the tie. The tie may or may not increase welfare.

In a pure bundling case, the components of the package are not sold separately. There is no observable benchmark of what their prices would be if there were no package but the sum of the profit-maximizing prices of the individual components could easily be more than the profit-maximizing price of the package. In a mixed bundling case, components are sold separately as well as in a package but it will be more expensive to purchase them alone. People "voluntarily" buy the package. This reflects the pricing of the components as much as it reflects the pricing of the package. The price of each individual component is set so as to extract surplus from its high valued users (users who value one of the components very highly but who place little value on the others) who self-select into buying it. Individuals buying only one component would be better off if bundling were prohibited. Individuals buying the bundle would be worse off. Faced with such ambiguity, competition policy should withdraw.

An unambiguously beneficial inducement is one in which package and stand alone prices reflect relative costs with the package being priced lower because of economies of joint production or distribution. A package priced above the sum of the stand alone prices of its components might still be attractive to customers if it reduced their search and transaction costs.

An inducement might be considered abusive if the mark-ups on cost are greater for the stand alone prices than they are for the bundle. Customers are "pushed" into buying the package by "artificially" high prices for its components. But this is the essence of price discrimination. Customers reveal their willingness to pay in opting for either the package or some of its components. Mark-ups on packaged vacations are less than mark-ups on travel and accommodation sold separately. This is because customers seeking both transportation and accommodation have a higher elasticity (lower willingness to pay) than customers seeking only accommodation or only transportation. This type of inducement is not cost-based but neither is it anticompetitive or necessarily welfare-reducing.

Pure bundling, a situation in which the customer is obliged to purchase two or more separate products together in a package and is precluded from purchasing them separately, might be

regarded as abusive. The question is relative to what? Stand alone prices are not observable. If the seller were forced into stand alone pricing, the sum of the stand alone prices it would set would not necessarily be lower than the price it had been charging for the package. Some customers would benefit but others would not and some would be priced out of the market.

A tie involving a complementary good for metering purposes might be regarded as abusive in that the customer is obliged to purchase the tied product at a price in excess of the price others are charging for it. Again the question is what is the alternative? The alternative is not simply "no tie." The tie might be replaced by a meter or a running royalty scheme of some kind. From the customer's perspective, this would make no difference except that it might be more costly for the customer and the seller to administer. If no such replacement were possible, the seller's only option would be to raise the price of the tying good. The most intensive users of the tying good would be better off. The less intensive users definitely would not be.

A tie involving substitutes might also be regarded by some as abusive. This again involves the imposition of an obligation on the buyer of the tying good to purchase the tied good at a price above the price at which it can be purchased elsewhere. Again, the question is what is the alternative? Analysis of this case usually makes the assumption that, without the tie, the tying good would be sold at its simple monopoly price. With the tie, the seller will find it profitable to reduce the price of the tying good so that the mark-ups on the tying and tied good are the same. The total amount that must be spent to acquire given amounts of the tying and tied goods may either rise or fall. If it falls, the customer is better off. If it rises, the customer is worse-off but the customer's losses may be less than the seller's increase in profit so that society as a whole (the seller and the customer together) is better off.

The essential point here is that tying or bundling may be the worst alternative except for all the others and the other alternatives are, in any case, frequently not observable. Structural indicators are preferable. A tie imposed by a seller with no market power can not be abusive. A tie cannot be abusive when the tying seller's share of the tied good market is small.

Treatment of Tying in the United States

Tying Under United States Antitrust Law

Tying is illegal per se under Section 1 of the Sherman Act (as a restraint of trade), Section 3 of the Clayton Act, Section 5 of the Federal Trade Commission Act and, for banks, under section 106 of the Bank Holding Company Act. The Clayton Act applies only to goods. Tying arrangements involving services must be brought under the Sherman Act. Although they differed at one time, the requirements for demonstrating that a tie is anticompetitive under either statute are now regarded as being indistinguishable. While tying remains a per se offence, the courts in the U.S. take a rule of reason type approach to it. This mixed approach is regarded as unsatisfactory by a minority of the Supreme Court but their view has not yet prevailed.

There are four requirements for *per se* illegality. First, the tying and tied products must be two distinct products. Second, the two products must be tied together. Third, the seller must have

economic power in the market for the tying product. Fourth, the dollar value of trade in the tied in the tied product must be non-trivial. The requirement that the seller have economic power in the market for the tying was often perfunctory. For example, in a 1969 case, United States Steel was found to have economic power with respect to the granting of credit (the tied good was prefabricated houses) even though its power in the market for credit was conceded by the court to have fallen far short of dominance (even that is a vast understatement) and to have existed only in the case of some of its customers.[108] In essence, the economic power requirement was deemed to have been met by the mere existence of a tie to which some customers objected.

In recent years, the requirements for a *per se* offence have been stiffened. First, the test for the existence of economic power in the market for the tying product has become more rigorous and more demanding. Since *Jefferson Parish* (1984), it has been required that the plaintiff show that the defendant has 30 percent or more of the relevant market for the tying good in order to establish that a tie is *per se* illegal.

Second, business justification defences (such as launching a new product) have been accepted as affirmative defences or have been used in support of conclusions that the two goods in question are not separate products. For example, an argument that a tied sale improves product quality and is thus pro-competitive may be used to rebut a claim of *per se* illegality. The pro-competitive and anti-competitive effects of the tie would then be balanced against each other in a rule of reason test.

Third, there has been movement in the direction of requiring that a tie be shown to result in anti-competitive foreclosure of the market for the tied good in order to establish *per se* illegality. One decision has gone as far as requiring that the plaintiff show that there is a substantial danger that the tying seller will acquire market power in the market for the tied product as a result of the tie. This constitutes a considerable advance on the earlier requirement that a tie merely affect a not insubstantial volume of commerce.

Tying Under the Bank Holding Company Act

Section 106 of the Bank Holding Company Act (BHCA) prohibits a bank from extending credit on the condition or requirement that the customer: (1) obtain some additional credit property or service from such bank, other than a loan, discount, deposit or trust service: (2) obtain any additional credit, property or service from a bank holding company of such bank or other subsidiary of such bank holding company; (3) provide some additional credit, property or service to such bank "other than those related to and usually provided in connection with a loan, discount deposit or trust service"; (4) provide any credit, property or service to a bank holding company or subsidiary of such bank holding company regardless of whether it is related to the loan or usually provided in connection therewith; or (5) not obtain some other credit, property or service from a competitor of such bank, a bank holding company, or any subsidiary of such bank holding company, other than a condition or requirement that such bank shall reasonably impose in a

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[108]This finding was subsequently reversed on appeal to the Supreme Court.

credit transaction to assure the soundness of credit." A bank is defined as any financial institution that accepts demand deposits and makes commercial loans.

Any person injured as a consequence of a violation of S.106 can sue for treble damages and injunctive relief. An extension of credit includes a loan commitment, forbearance on collecting an outstanding loan and refinancing an existing loan. Section 106 has been interpreted so as to permit any condition that in some way enhances the lender's security.

Section 106 differs considerably from Sherman and Clayton Act proceedings in the burden it puts on the plaintiff. There is no obligation on the plaintiff to show either that the tying bank has market power in the market for the tying good or that a substantial volume of commerce is involved. Apparently Congress wished to avoid a full scale antitrust analysis. What a BHCA plaintiff must show in order to establish that there has been a per se violation is that the tie in question benefits the bank in some way unrelated to the enhancement of its security as a lender or results in unfair competition or lessens competition. Showing an anticompetitive effect is sufficient but it is not necessary and it would "eviscerate" the statute if it were.

Economists have questioned the need for Section 106, arguing that sufficient protection of borrower interests could be obtained by applying Section 3 of the Clayton Act to banks. White (1995) notes that in a competitive environment, sellers will seek out the bundles that most likely to find favour with their customers. This will depend on customer tastes, relative costs, management expertise, technology available, among other considerations. These bundles may not be appropriate for all potential customers but in a competitive market a bundle that is not attractive to a sufficient number of customers or it will be withdrawn. White goes on to argue that local banking markets in the United states are sufficiently competitive that no one bank could profitably impose a tie that was not in the interest of the bulk of its customers. It is conceivable that the banks in a given local market could collectively impose a tie that forced their depositors to purchase a particular financial service from them and thus foreclosed the market to nonbank suppliers of that service. White argues that collusive agreements to tie have been extremely rare and this may indicate the difficulty of reaching and enforcing agreements of this sort.

White concedes that, even in a competitive market, a bank may attempt to exploit its existing customer base by forcing these customers to purchase bundles of financial services they would not otherwise purchase. Some customers may leave but many will not find it worth their while to do so. This is a form of what is known as "installed base opportunism" and it is discussed in more detail below. While a bank or the seller of any other good or service may derive a short-run advantage in exploiting customers that have made a commitment to it, the development of a reputation for exploitative behaviour will make it very difficult to attract new customers. It would surely be to the advantage of at least some competitors to guarantee not to alter the terms on which a customer has signed up. In any event, there are innumerable ways, other than tying, in which a seller can exploit committed customers (or customers can exploit a committed seller). A common example is failing to live up to representations regarding post-sales service. The essential point is that these are contract problems not antitrust problems.

Section 106 does not require a demonstration either that the bank in question has market power in the tying product market or that the tie reduces competition in the tied market. It employs an antitrust remedy (treble damages) intended to punish the subversion of competition to a contracting problem. White reports (1995, p.32) that "... virtually all of the law suits involving Section 106 have been brought by disgruntled borrowers or would-be borrowers: those who have defaulted on their loans, who have had loans restructured or who have been denied credit."

White's view is that Section 106 has probably inhibited banks from offering bundles of services that would be efficient and attractive to customers for fear that a bank or a nonbank rival may launch a treble damage suit. Bundling is an especially valuable tool in situations in which one party in a transaction does not have full information about the other. As suggested above, tying is a means of contingent payment. The tie is profitable to the seller only if the tying good turns out to be of value to the buyer. This is useful in the case of new technologies. It is also useful in financial transactions, for example, by allowing a lender to participate in the upside of a loan transaction thereby reducing the agency problem of debt. Lenders and borrowers should not be precluded from structuring their relationship to their mutual benefit.

Tying in Canada

There have been two contested tying cases in Canada. Another case (*Digital*) was settled with undertakings to unbundle in 1992. In the first contested case, the Director sought and obtained an order requiring the Bureau of Broadcast Measurement (BBM) to unbundle its sale of radio and television ratings in 1981. This application was brought under the *Combines Investigation Act*, the statute which preceded the *Competition Act.* The second tying case is *Tele-Direct.* This case is described below.

Tele-Direct

The Tele-Direct case was decided by the Competition Tribunal on February 26, 1997. The case took two years to decide. It involved allegations of abuse of dominant position as well as tying. It is the tying allegations that are examined here. The Director alleged that Tele-Direct was bundling the sale of advertising design and layout services with the sale of advertising space in its directories for certain classes of customers contrary to Section 77 of the Competition Act. The Director sought an order requiring Tele-Direct to sell advertising space and advertising services separately, that is, to allow outside agencies to provide advertising copy for insertion in Tele-Direct directories. The Tribunal ultimately issued an order requiring the unbundling of advertising space and services for some classes of customers.

In its decision the Tribunal devoted considerable space to the issue of product market definition. It concluded that telephone directory advertising was a relevant product market. Insofar as the allegations of tying were concerned, however, the directory advertising space market and the advertising services market were the two relevant markets. The Tribunal failed to define either product or to undertake any serious analysis of the advertising services market (Wong, 1997 ¶.58; Musgrove and Edmonstone, 1997, pp. 30-31). Thus, there is little in the way of foundation for

its ultimate conclusion that the tie substantially lessened competition in the supply of the tied good (advertising services).

The Tribunal found on the basis of its market share and the existence of barriers to entry that Tele-Direct had market power in the supply of directory advertising and presumably advertising space. This is sufficient but not necessary to meet the "major supplier" requirement in Section 77. The second requirement is that the tying and tied good be two products. The test enunciated by the U.S. Supreme Court in this regard is that the tied good is a separate good if there is a viable stand-alone demand for it. The Tribunal concluded that advertising space and services were two products on the grounds that larger advertisers preferred to purchase their advertising services from agents or consultants rather than Tele-Direct. As Wong (1997, ¶.59) points out, there are some problems with this conclusion. Advertising services apparently include sales effort. But this implies that use of an internal sales force (vertical integration) is tying which it surely is not. Moreover, selling space involves showing prospective clients how that space can be used. The selling and design functions are inherently integrated.

Smaller customers had no interest in separate sourcing of space and advertising services and independent agents had no interest in supplying advertising services to them. The largest customers (national accounts and so-called eight market accounts) were already able to purchase services and space separately. The Tribunal saw the issue as one of slightly reducing the threshold (size of customer) at which directory space and advertising services were unbundled. It concluded that advertising services and directory space should be unbundled for accounts advertising in six or more markets. In essence the Tribunal decided that advertising services and directory space were two goods for those classes of customers that independent agents were interested in supplying.

Section 77 requires that the effect of a tie be to lessen competition substantially in the market for the tied good if an order is to be issued. The usual argument is that a tie lessens competition in the market for the tied good by foreclosing the market for the tied good to other suppliers. This may keep new competitors from entering or may raise the costs of existing competitors. The determination of whether this scenario is likely to play out requires an analysis of the structure of the market for the tied good. The Tribunal did not undertake such an analysis. Indeed, it could not have done so given that it had not defined the market for the tied good. Musgrove and Edmonstone (1997) suggest that had the tribunal undertaken the requisite analysis it would have found that the market for advertising services is not confined to the provision of advertising copy for telephone directories but is much broader and probably also relatively easy to enter. As a consequence, the Tele-Direct share of the market for the tied good was probably small and it did not have the ability to restrict competition in that market. Indeed, the leverage theory is questionable even without an analysis of the market for the tied good. If Tele-Direct was intending to lever its monopoly power in the directory space market into the advertising services market, wouldn't it have insisted that all accounts be bundled rather than leaving the largest and presumably most lucrative accounts unbundled?

Rather than analyzing the consequences of the tie for competition in the market for the tied good, let alone for economic welfare, the Tribunal confined itself to a comparison of the value of directory advertising it thought *should have been* commissionable (unbundled) which was

$19 million with the value of directory advertising that was already commissionable which was $30 million. In the Tribunal's view, the total market for which agents should have been allowed to compete should have been $49 million but it was only $30 million and this constituted a substantial lessening of competition. In emphasizing the magnitude of the sales which should be unbundled rather than defining the market for advertising services and analyzing the consequences of the tie for competition in the market so defined, the Tribunal appears to have followed the U.S. approach which requires only that the tie affect a substantial volume of interstate commerce.

The order issued by the Tribunal in *Tele-Direct* required Tele-direct to unbundle the sale of directory advertising space and services for advertisers placing advertisements in six or more markets (directories). The Tribunal declined to set rates for space and advertising services on the well-established grounds that it is not a price regulator. It suggested that Tele-Direct could comply with its order by paying the same 15 percent commission to independent agents handling the newly unbundled accounts as it has paid to agents handling the larger, already unbundled accounts. If all the accounts subject to the order were ultimately handled by agents, the commissions involved would be $2.85 million annually.

Installed Base Opportunism

Relevance to Financial Services

It is said that consumers of financial services do not shop around or are ignorant about lifetime costs of the contracts they enter into. They may not realize that some services are bundled and that this bundling is more costly to them. Information costs are high in the financial services market. Consumers may not realize there are unbundled alternatives available to them. It may also be the case that consumers of financial services shop around initially for the best deal but once they make their choice they are locked in to a relationship with a financial services provider and therefore vulnerable to opportunism. Of course the vulnerability is mutual and many of the actions taken by lenders are designed to forestall opportunism by borrowers.

Leading U.S. Case: Kodak

Kodak tied the purchase of repair services to the purchase of Kodak parts for Kodak copiers. The ISO's sued. Kodak moved for summary judgement on the grounds that it had no market power in the copying equipment market and therefore requirements for a per se offence were not met. The trial court granted Kodak's motion for summary judgement. The appeal court reversed and was upheld by the Supreme Court on the grounds that Kodak had market power in the supply of Kodak parts for Kodak copiers. The case subsequently went to trial and the ISO's were awarded nearly $75 million in treble damages. This decision is currently under appeal.

The finding by the majority on the Supreme Court that a firm can have market power in the aftermarket even though it has no market power in the "foremarket" has been controversial. In this regard, the dissenting minority on the Supreme Court made some points that are of general

importance for competition policy and which are also highly relevant to concerns raised regarding tying behaviour in the financial services industry and by Schedule I banks in particular.

The Supreme Court minority noted that had Kodak bundled parts and service with the original equipment purchase, there would have been no antitrust problem to start with because there was no market power in the tying good. The perceived antitrust problem arose because Kodak bundled service with parts and it was perceived to have market power in that it was a monopoly supplier of Kodak parts. The minority pointed out the incongruity of a situation in which excluding ISO's from the outset is a legal tie (or at least not *per se* illegal) while allowing ISO's and subsequently excluding them is illegal.

Had Kodak – from the date of its entry into the micro-graphics and photocopying equipment markets – included a lifetime parts and service warranty with all original equipment, or required consumers to purchase a lifetime parts and service contract with each machine, that bundling of equipment, parts and service would no doubt constitute a tie under the tests enunciated in *Jefferson Parish Hospital Dist. No. 2* v. *Hyde*. Nevertheless, it would be immune from *per se* scrutiny under the antitrust laws because the *tying* product would be *equipment*, a market in which (we assume) Kodak has no power to influence price or quantity. The same result would obtain, I think, had Kodak – from the date of its market entry – consistently pursued an announced policy of limiting parts sales in the manner alleged in this case, so that customers bought with the knowledge that aftermarket support could be obtained only from Kodak. The foreclosure of respondents from the business of servicing Kodak's micrographics and photocopying machines in these illustrations would be undeniably complete – as complete as the foreclosure described in respondents' complaint. Nonetheless, we would inquire no further than to ask whether Kodak's *market power* in the equipment market effectively forced consumers to purchase Kodak micrographics or photocopying machines subject to the company's restrictive aftermarket practices. If not, that would end the case insofar as the *per se* rule was concerned. The evils against which the tying prohibition is directed would simply not be presented. Interbrand competition would render Kodak powerless to gain economic power over an additional class of consumers, to price discriminate by charging each customer a "system" price equal to the system's economic value to that customer, or to raise barriers to entry in the interbrand equipment markets.

It is quite simply anomalous that a manufacturer functioning in a competitive equipment market should be exempt from the *per se* rule when it bundles equipment with parts-and-service, but not when it bundles parts with service. This vast difference in the treatment of what will ordinarily be economically similar phenomena is alone enough to call today's decision into question.

There may be many customers who profess not to like the tie but knew about it when they made their purchases and they had alternatives. There are advantageous and disadvantageous parts of all contracts. Antitrust law does not exist as a means of escaping the portions of contracts we find burdensome. There may also be customers who did not look at the lifetime cost of the equipment they purchased or did not know that there were competitors offering alternative packages. The minority makes the point that *antitrust policy is not made for the lowest common denominator of consumer who doesn't shop around*:

> True, there are – as the Court notes – the occasional irrational consumers that consider only the hardware cost at the time of purchase (a category that regrettably includes the Federal Government, whose "purchasing system," we are told, assigns foremarket purchases and aftermarket purchases to different entities). But we have never before premised the application of antitrust doctrine on the lowest common denominator of consumer. (p.6)

Consumers may remain rationally ignorant of lifetime costs and/or of competitive alternatives. Market share may be less sensitive to changes in back-end loaded prices or in service quality.[109] Information costs do make for bands of price indifference thus giving individual brands pricing discretion. The exploitation of this discretion generally results in prices above marginal cost. This is true of all markets in which products are differentiated in some way (and this is most markets). The exploitation of pricing discretion by individual sellers in differentiated products markets has never been an antitrust matter. It is not the exercise of market power in the sense that the term has been used in antitrust policy:

> The Court attempts to counter this theoretical point with theory of its own. It says that there are "information costs" – the costs and inconvenience to the consumer of acquiring and processing life-cycle pricing data for Kodak machines – that "could create a less responsive connection between service and parts prices and equipment sales." But this truism about the functioning of markets for sophisticated equipment cannot create "market power" of concern to the antitrust laws where otherwise there is none. "Information costs," or, more accurately, gaps in the availability and quality of consumer information, pervade real-world markets; and because consumers generally make do with "rough cut" judgments about price in such circumstances, in virtually any market there are zones within which otherwise competitive suppliers may overprice their products without losing appreciable market share. We have never suggested that the principal players in a market with such commonplace informational deficiencies (and, thus, bands of apparent consumer pricing indifference) exercise market power in any sense relevant to the antitrust laws. "While [such] factors may generate `market power' in some abstract sense, they do not generate the kind of market power that justifies condemnation of tying."

Locked-in customers are vulnerable but this is true of any buyer or seller who makes an irreversible commitment. It is important to distinguish between market power and circumstantial power. In a competitive market, both buyers and sellers will be able to negotiate protection against the subsequent exercise of circumstantial market power.

> Leverage, in the form of *circumstantial* power, plays a role in each of these relationships; but in none of them is the leverage attributable to the dominant party's *market* power in

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[109] This raises the possibility that application of the hypothetical monopolist test could yield different product and geographic market boundaries depending on the margin(s) on which the hypothetical monopolist is assumed to raise price. For example, a 5 percent (effective) price increase brought about either by raising back-end loaded prices or reducing service quality may yield a different consumer response than a 5 percent price increase brought about by raising front-end loaded prices.

> any relevant sense. Though that power can plainly work to the injury of certain consumers, it produces only "a brief perturbation in competitive conditions – not the sort of thing the antitrust laws do or should worry about." (p.7)

The Influence of the Kodak Decision

As the Supreme Court minority predicted, the effect of the Court's decision in Kodak was to result in a flood of "aftermarket rights" cases although few have succeeded (Wall, 1997). Several decisions have expressed opinions about what they consider to be the doctrinal essence of the Kodak decision. They have expressed the view that the offence lies in the policy change, that is, in the opportunistic imposition of not only supra-competitive, but higher than promised after-market prices on locked-in customers. According to this view, consistent policy of tying parts and service contracts to sales of original equipment is not a *per se* offence if the supplier involved has no market power in the original equipment market. If they know about the tie, consumers who do not like its implications for life cycle costs can turn to other original equipment manufacturers. Under these assumptions, after-market monopolization is impossible. While this limits the precedential role of the Supreme Court's Kodak decision, it is not entirely satisfactory. It is far from clear that a change in policy to exclude ISO's is an antitrust issue any more than a decision to discontinue a line or to stop supporting it. These remain essentially contract issues.

A Canadian Case: Digital

The Digital case involved allegations of tied selling. Complaints were received by the Bureau in 1990-91 alleging that Digital was requiring that purchasers of its proprietary VMS operating system updates and service for their (Digital) VAX computers also have the computers themselves (the hardware) serviced by Digital rather than by independent service organizations (ISO's). Digital's bundling policy is described by Hunter and Hutton (1992) as follows:

> Beginning in 1988, however, Digital introduced an integrated service policy which linked the provision of hardware servicing for its systems to software service for its proprietary operating and applications programs. Under the integrated service policy, Digital customers were denied access to software hotlines and bulletin boards unless they contracted for both software and hardware servicing from Digital. The hotlines and bulletin boards were, however, free of charge to integrated service customers. This served as an inducement to customers who – in the light of Digital's proprietary rights in the software – were more or less obliged to use Digital's software services if they wanted to receive software upgrades and debugging services. The integrated service pricing policy was the carrot, and a prohibitively high price for stand-alone software upgrades was the stick. (p.2)

The case was settled in October 1992 with an undertaking by Digital to unbundle hardware servicing and software updates and service but without any admission that tied selling as defined under Section 77 had in fact taken place. The settlement is characterized by Hunter and Hutton (1992) as follows:

> Essentially, all components of the integrated service will be available separately, at stand-alone prices which do not add up to more than the price of the integrated service. As the independent hardware servicers were involved in the negotiations for the undertakings, it is clear that they are satisfied that they will now be able to effectively compete in the market for after-sales servicing of Digital computer systems. (p.3)

At the time of the complaints, Digital accounted for approximately one-third of the sales of new mid-range computers. It was Digital's position that it had no market power in the market for mid-range computers so that potential purchasers of new VAX computers could readily turn to other computer manufacturers if they did not like the computer plus service package Digital was offering. Digital's position was, in essence, that a bundled equipment-service offering that survives in a reasonably competitive market must be efficient. The Bureau, in turn, wanted direct evidence as to the efficiencies resulting from bundling (technical justification for the tie) and was apparently not satisfied with the evidence that was adduced. Particularly telling from the Bureau's perspective was evidence that many owners of VAX computers would have preferred to deal with the ISO's and that hardware servicing and VMS operating software upgrades and service were not bundled in the United States or Australia.

There does not appear to have been much discussion of the question of leverage in this case. Digital accounted for roughly 10 percent of the computer hardware servicing business in Canada at the time. The possibility that Digital could have levered its way to dominance of the computer hardware servicing business or even contemplated doing so is remote. Digital clearly did dominate the servicing of its own brand of computer and the Bureau may have been prepared to argue that the servicing of this one brand constituted a market. Insofar as the servicing of the existing stock of Digital computers was concerned, Digital exercised what the U.S. Supreme Court has called "circumstantial market power" which is the power that one party in a transaction holds over the other party when the other has made an irreversible commitment.

Implications of Tele-Direct and Digital in the Light of Kodak

There is good news and bad news for firms in the financial services industry who are worried about being the victims of tying arrangements. The good news is that the two Canadian cases under the *Competition Act* as well as the earlier case *(BBM)* brought under the *Combines Investigation Act* to date have demonstrated an overwhelming concern on the part of both the Bureau and the Tribunal with the well-being of excluded competitors.

The Bureau, at least, appears prepared to define the after-market for a single brand as a relevant market even though there are a number of close substitutes for that brand. An interesting question is whether the Bureau (and the Tribunal) would also be prepared to define the customers of a financial institution as a relevant market on the grounds that they are locked into a relationship with that institution in the same way that owners of Digital VAX computers were locked in to a relationship with Digital. The reasoning in *Digital* might be extended to imply, for example, term loans from the Bank of Montreal are a relevant market on the grounds that term loan customers of the Bank of Montreal are locked-in to a relationship with the Bank of Montreal and cannot readily go elsewhere, however much they may have shopped around beforehand. The Tribunal's reasoning in *Tele-Direct* could be taken to imply that a tie applying to a substantial

portion of a financial institution's own customers lessens competition substantially regardless of the characteristics of the market for the tied good.

Of course, Section 77 does not require that the tying firm have market power in the market for the tying good. It requires only that the tying firm be a major supplier or that tying be widespread in the market. Thus, Digital's lack of market power in the market for mid-sized computers might have been no defence in that Digital could still have been regarded as a major supplier. Similarly, a large Schedule I bank might still be a major supplier of financial services for purposes even though it has no market power in the provision of those services. This, together with the Tribunal's apparent lack of concern with conventional analysis of the effect of a tie on competition in the tied good market might bring a number of potential package marketing practices under scrutiny.

The other good news for putative victims of tying arrangements is that neither the Bureau nor the Tribunal has been much concerned with showing a lessening of competition in the tied good. In Digital, no consideration was given to the effect of bundling on competition in computer hardware servicing in general even though most ISO's serviced more than one brand of computer. It was apparently sufficient that some ISO's who had formerly serviced Digital computers were prevented from doing so by the integrated service policy. In *Tele-Direct*, the Tribunal paid no attention whatever to the effect of the tying of advertising layout services to the sale of directory space had on competition in the market for advertising layout services. The Tribunal simply compared the value of the advertising (not the layout services) it thought should have been commissionable with the value of the advertising that was already commissionable and deemed the ratio to be substantial. In so doing, the Tribunal appears to have adopted the U.S. approach of requiring only that a tie affect a substantial volume of commerce rather than lessen competition substantially in a relevant market.

Conclusions

The limited record of Section 77 enforcement (as well as Section 31(4) of the Combines Investigation Act before it) reveals itself to be exceedingly victim friendly. The bad news (for firms perceiving themselves to be victims of ties) is that the remedies are modest and while proceedings are relatively quick, they may not be quick enough to protect aggrieved competitors in some fast-moving markets. Nor could the Director handle a large number of them at a time.

Canadian cases serve to illustrate the reasons why the *Competition Act* provides such limited remedies for reviewable practices that are found to be anti-competitive. Given the marginal change in the selling practices of Tele-Direct required to eliminate their anti-competitive effect it is hard to imagine how the public interest could be served by a regime of treble damages.[110] If that were the remedy, the process would likely become less victim friendly in a hurry.

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[110] If agents earned 15 percent profit on their 15 percent commissions, single damages in *Tele-Direct* might have amounted to $430,000 for each year that anti-competitive bundling was found to have occurred. The actual deadweight loss to the economy would likely be much smaller.

The financial services industry is a multiproduct industry. As such, it presently offers endless opportunities for tying and bundling arrangements. Firms may increase their opportunities for tying or bundling by mergers or acquisitions which add product lines. They can also do this without mergers by means of strategic alliances and cooperative marketing arrangements.

Tying and bundling can be means of effecting price discrimination. It can be a manifestation of market power although it frequently occurs in differentiated products markets with large numbers of competitors. Firms in financial services markets now have the ability and incentive to engage in tying and bundling. Mergers among Schedule I banks might further increase the ability of the merged banks to engage in tying and bundling. To the extent that this would likely be harmful to a particular group of customers, it would be factored into the merger assessment process. To the extent that it could be exclusionary and thus lessen competition in the markets for the tied goods involved, it would be factored into the merger assessment process as well as being covered under Section 77 of the *Competition Act.*

IX. Abuse of Dominance

Introduction

Although this study is principally about mergers, there are useful lessons to be derived from an examination of Canadian law, jurisprudence and enforcement experience with respect to the abuse of dominance. First, abuse of dominance provisions back up merger provisions. If remedies for abuse of dominance or joint dominance are effective than there is less to lose from having failed to challenge a merger that turns out to increase market power. In statistical terms, the existence of effective remedies for abuse of dominance reduce the costs of committing a Type II error in merger enforcement.

Second, a great deal of the jurisprudence developed by the Tribunal in abuse cases also applies in merger cases. Much of the jurisprudence on geographic and product market definition and barriers to entry has been developed in abuse cases.

Third, the majority of the contested cases heard by the Tribunal have been abuse cases. It is difficult to provide a balanced assessment of the adequacy of the institutions of competition law and policy in Canada without considering the enforcement record of the abuse of dominance provisions of the *Competition Act.*

Fourth, concerns regarding the maintenance of competition in the financial services industry go well beyond merger evaluation. While this study cannot address all these concerns, the discussion of the remedies for the abuse of dominance or joint dominance presented here may address some of the more pressing competition concerns.

Abuse of Dominance in the Competition Act

Anti-Competitive Practices in the Competition Act

An illustrative list of potentially anti-competitive practices is given in section 78 of the Competition Act. Section 78 reads as follows:

> **78.** For the purposes of section 79, "anti-competitive act", without restricting the generality of the term, includes any of the following acts:
>
> (a) squeezing, by a vertically integrated supplier, of the margin available to an unintegrated customer who competes with the supplier, for the purpose of impeding or preventing the customer's entry into, or expansion in, a market;
>
> (b) acquisition by a supplier of a customer who would otherwise be available to a competitor of the supplier, or acquisition by a customer of a supplier who would otherwise be available to a competitor of the customer, for the purpose of impeding or preventing the competitor's entry into, or eliminating the competitor from, a market;

(c) freight equalization on the plant of a competitor for the purpose of impeding or preventing the competitor's entry into, or eliminating the competitor from, a market;

(d) use of fighting brands introduced selectively on a temporary basis to discipline or eliminate a competitor;

(e) preemption of scarce facilities or resources required by a competitor for the operation of a business, with the object of withholding the facilities or resources from a market;

(f) buying up of products to prevent the erosion of existing price levels;

(g) adoption of product specifications that are incompatible with products produced by any other person and are designed to prevent his entry into, or to eliminate him from, a market;

(h) requiring or inducing a supplier to sell only or primarily to certain customers, or to refrain from selling to a competitor, with the object of preventing a competitor's entry into, or expansion in, a market; and

(i) selling articles at a price lower than the acquisition cost for the purpose of disciplining or eliminating a competitor.

Requirements for a Substantial Lessening of Competition

Section 79 gives the circumstances under which acts such as those listed in Section 78 are likely to be regarded as abusive and also lists the remedies available to the Director. Section 79 reads as follows:

79. (1) Where, on application by the Director, the Tribunal finds that

(a) one or more persons substantially or completely control, throughout Canada or any area thereof, a class or species of business,

(b) that person or those persons have engaged in or are engaging in a practice of anti-competitive acts, and

(c) the practice has had, is having or is likely to have the effect of preventing or lessening competition substantially in a market,

the Tribunal may make an order prohibiting all or any of those persons from engaging in that practice.

(2) Where, on an application under subsection (1), the Tribunal finds that a practice of anti-competitive acts has had or is having the effect of preventing or lessening competition substantially in a market and that an order under subsection (1) is not likely to restore competition in that market, the Tribunal may, in addition to or in lieu of making

an order under subsection (1), make an order directing any or all the persons against whom an order is sought to take such actions, including the divestiture of assets or shares, as are reasonable and as are necessary to overcome the effects of the practice in that market.

(3) In making an order under subsection (2), the Tribunal shall make the order in such terms as will in its opinion interfere with the rights of any person to whom the order is directed or any other person affected by it only to the extent necessary to achieve the purpose of the order.

(4) In determining, for the purposes of subsection (1), whether a practice has had, is having or is likely to have the effect of preventing or lessening competition substantially in a market, the Tribunal shall consider whether the practice is a result of superior competitive performance.

(5) For the purpose of this section, an act engaged in pursuant only to the exercise of any right or enjoyment of any interest derived under the Copyright Act, Industrial Design Act, Patent Act, Trade-marks Act or any other Act of Parliament pertaining to intellectual or industrial property is not an anti-competitive act.

(6) No application may be made under this section in respect of a practice of anti-competitive acts more than three years after the practice has ceased.

(7) No application may be made under this section against a person

(a) against whom proceedings have been commenced under section 45, or

(b) against whom an order is sought under section 92

on the basis of the same or substantially the same facts as would be alleged in the proceedings under section 45 or 92, as the case may be.

Interpretation of Sections 78 and 79

In order for the Tribunal to issue a remedial order under section 79 it must be satisfied that the party or parties engaging in the practice of anti-competitive acts have market power in the relevant product market (substantial or complete control of a class or species of business) and that the anti-competitive acts involved are likely to lessen competition substantially. Market power can be exercised either jointly or unilaterally. A monopoly is sufficient but not necessary for market power to exist.

Among the more important of the illustrative anti-competitive acts are margin squeezing of non-integrated rivals by vertically integrating firms and foreclosure of either sources of supply or market outlets to non-integrated firms by integrated firms. It has been alleged that the potential for anti-competitive squeezes exists in the financial services industry. A possible example might involve independent brokers and securities dealers who may rely on banks to finance their activities but must also compete with bank-owned brokers and dealers. It is suggested that banks

might be able to squeeze their non-integrated rivals by raising their cost of finance or perhaps even foreclose the supply of finance by refusing to lend to them at all.

A second class of illustrative anti-competitive acts involves discriminatory price cutting (fighting brands, freight equalization) or related activity by dominant incumbent in response to new entry. The argument is that the incumbents competitive response should not be targeted on the new entrant. This argument has recently been cast into doubt by the Tribunal's funding in Tele-Direct (see below) that it is reasonable to expect incumbents to compete where there is competition.

A third class of illustrative anti-competitive act is the preemption of scarce facilities (similar to foreclosure of sources of supply) and the adoption of incompatible product standards (thereby foreclosing a market).

The abuse cases heard by the Tribunal have involved a variety of other alleged anti-competitive acts. These include exclusive contracts (*NutraSweet, Neilsen*) and restrictive contract termination provisions (*Laidlaw*)

Abuse of Dominance Cases Decided by the Tribunal

Contested Cases

There have been four contested cases under Section 79. These are *NutraSweet, Laidlaw, Nielsen* and *Tele-Direct.*[111] The Director of Investigation and Research has been successful in obtaining some sort of remedial order in all four cases.

In *NutraSweet* the Tribunal found that NutraSweet Company (NSC) had engaged in a practice of anticompetitive acts involving exclusive contracting, meet or release clauses and most favoured nation clauses in the supply of aspartame. The inducements to enter exclusive contracts included various discounts and allowances as well as the right to display the NutraSweet logo. The Tribunal concluded that these contracting practices prevented the entry of competing suppliers and the prevention of competition involved was substantial.

In *Laidlaw*, the Tribunal found that Laidlaw Waste Systems had engaged in anticompetitive acts including acquiring competitors and engaging in restrictive termination and other contracting practices in the supply of waste collection and disposal services in four areas of the province of British Columbia. The Tribunal ordered that Laidlaw reduce the penalties for early termination of its contracts and also change the renewal provisions.

In *Nielsen*, the Tribunal found that the A.C. Nielsen Company had engaged in a practice of anticompetitive acts involving exclusive contracting for supermarket scanner data. The control by Nielsen of scanner data effectively excluded competing suppliers of retail market analysis

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[111] Canada (DIR) v. NutraSweet Co. (1990), 32 C.P.R. (3d) 1 (Comp.Trib.); Canada (DIR) v. Laidlaw Waste Systems Ltd. (1992), 40 C.P.R. (3d) 289 (Comp. Trib.); Canada (DIR) v. The D&B Companies of Canada Ltd. (1996), 64 C.P.R. 216 (Comp. Trib.).

services from the market. The Tribunal ordered that Nielsen cease the practice of exclusive contracting and supply historic scanner data to a competitor.

The allegations of abuse of dominance in *Tele-Direct* involved two types of anti-competitive acts. The Director alleged, first, that Tele-Direct had attempted to exclude new entrants into directory publishing and second, that it had attempted to exclude advertising agents and consultants from the sale and production of advertisements in Yellow Pages directories. In addition, the Director alleged that Tele-Direct had tied the sale of advertising services to the sale of advertising space contrary to Section 77 of the competition Act. The tying case is discussed at length in Section VIII above.

With respect to the exclusion of new entrants, the Director alleged that Tele-Direct had engaged in unfair targeting of new entrants in that its competitive tactics were different in communities in which there were competing directories. Tele-Direct had responded to new entry with price cuts, product improvements and increased advertising. The Tribunal rejected the argument that these actions were anti-competitive, noting that it would expect Tele-Direct to compete where it has competition and that customers benefitted from this competition. The Tribunal did find, however, that Tele-Direct had used its bargaining power to keep one of its suppliers from also supplying a rival directory. The Tribunal concluded that this action not only disadvantaged the rival directory but also had a negative effect on customers and it was therefore anti-competitive in the sense of Section 79. The Director had, however, not requested a remedy for this act.

With respect to anti-competitive acts directed at advertising agents, the Director alleged that Tele-Direct had squeezed their margins and had discriminated against them by providing space and other services on more favorable terms to its own sales force. The Tribunal found, however, that Tele-Direct had a relatively small share of the agency business (where it was permitted) and thus its actions could not be construed to have lessened competition substantially however annoying these actions may have been to its competitors.

Consent Orders

There have been two consent orders issued by the Tribunal under Section 79. The first, issued in November, 1994, involved the marketing of national advertising (advertising appearing in two or more directories) in the Yellow Pages and is referred to as the *CANYPS* case. The Order required that publishers of Yellow Pages Directories allow independent agents to sell national advertising space and that publishers cease to require that national advertisers book space from the telephone company in the province in which their head office was located. The supply of Yellow Pages Directory advertising space itself remained in the hands of a set of local monopolies which presumably continued to set a monopoly price for their products. In addition, economies of integrating the supply and marketing of advertising space may have been foregone. The implication is that the likely effect of the Order would have been to decrease rather than increase the output of Yellow pages national advertising space.

The second consent order issued under Section 79 was in *Interac*. The Order provided for a number of changes in the rules of the Interac electronic banking network. The intent of the Order was to facilitate intranetwork competition and to improve access to network membership.

Interac members are to be allowed to charge different fees for services such as cash dispensing and to enter bilateral or multilateral arrangements with other Interac members to offer new services. The Order also requires that qualifying nonfinancial companies be allowed own their own debit card equipment and to own cash dispensing machines linked to the Interac network.

Joint dominance cases involving networks raise a number of interesting issues. These include the trade-off between internetwork and intranetwork competition, the trade-off between the incentive to innovate with respect to networks and the facilitation of *ex post* network access and the trade-off between intranetwork coordination and intranetwork competition.[112] These issues are discussed in the recent Federal Trade Commission's recent report on innovation and global competition.[113] The Tribunal's decision in *Interac* is discussed in greater detail below.

Jurisprudence from Abuse Cases

Product Market Definition

A good illustration of the application of the hypothetical monopolist test to product market definition is provided by the Tribunal's reasoning in *NutraSweet*. The question here was whether the product market should be defined as aspartame or more broadly as high-intensity non-caloric sweeteners or more broadly yet as non-caloric sweeteners or most broadly as caloric and non-caloric sweeteners. The Tribunal reasoned as follows:

> The best way of judging the extent to which the price of aspartame is constrained by sweeteners currently on the market, and those that are anticipated to be introduced, is to compare the price of aspartame in jurisdictions where the only competition comes from these other sweeteners to the price where there is at least the possibility of competing aspartame suppliers. The former is the case in the United States where the use patent has been extended; the latter is the case in Canada. The average price of aspartame in the United States is more than 50 percent higher than it is in Canada. Alternative sweeteners do not provide sufficient competition to limit the market power of NSC in the United States.[114]

Fundamental to product market definition is the assessment of the ability of buyers to switch from the product in question to substitute products. A summary measure of the extent to which an increase in the price of one product increases the demand for another is the cross elasticity of demand between the two products. Purported cross elasticity evidence was submitted to the Tribunal in *NutraSweet*. It took the form of the ratio of the change in the proportion of carbonated soft drink sales accounted for by diet soft drinks to the change in the price of aspartame relative to sugar. The Tribunal correctly rejected this evidence on the grounds that it

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[112]For example, the bank card of one institution and the cash machines of another are complements and it is efficient to price them jointly. The cards and the cash machines of the two institution are substitutes, however, making joint pricing inefficient.

[113]Federal Trade Commission (1996) Ch.9.

[114]Canada (DIR) v. NutraSweet Co. (1990), 32 C.P.R. (3d) 19.

did not hold other factors (such as changes in income, tastes and demographics) constant and on the grounds that the changes in the prices of these ingredients did not, in fact, flow through to the final product.

The Tribunal revisited the problem of product market definition in a differentiated products market in its *Nielsen* decision. This decision was issued three weeks after the Federal Court of Appeal decision in *Southam*. The question in *Nielsen* was whether the product market should be defined as scanner-based market tracking services or more broadly, as market tracking services based on information derived from audit, warehouse shipment or consumer panel data as well as scanner data.

The Tribunal's analytical framework and its application was similar to that which it had employed in *Southam:*

> The standard test for establishing whether products that are differentiated in one or more ways are close substitutes and therefore in the same product market is to determine whether small changes in relative price would cause buyers to switch from one product to another. Direct evidence of switching behaviour in response to small changes in relative price would provide proof of substitutability. Where price and quantity changes are not in evidence, as is true in the instant case, it is necessary to answer the question less directly by examining the evidence of both buyers and suppliers regarding the characteristics, the intended use and the price of various types of market tracking services. ... In the instant case the evidence focused on the timeliness, detail, accuracy, reliability and cost of collection of the data and the extent to which product movement data can be combined with causal data.[115]

The Tribunal found that audit, warehouse shipments and consumer panel data were not functionally equivalent to scanner data. As the basis for this finding, the Tribunal cited testimony from customers that they regarded scanner data as superior to audit or warehouse shipment data with respect to timeliness, detail, accuracy and other important characteristics. The Tribunal found scanning data superior to consumer panel data for tracking purposes on the basis of "objective" characteristics such as sample size (hence reliability and detail)and timing. It went on to cite evidence that customers tended to purchase both scanner-based and consumer panel-based services, relying on one for product tracking and on the other for consumer diagnostics as the basis for a conclusion that scanner and consumer panel-based services were "supplements" rather than substitutes.

The Tribunal concluded that the evidence "overwhelmingly" favoured the narrower, scanner-based tracking services definition of the product market. The Tribunal devoted a considerable portion of its judgement in *Nielsen* to the issue of product market definition. Perhaps reflecting the experience gained in *Southam*, there is detailed consideration of evidence from customers regarding both functional equivalence as well as the possibilities for substitution and for playing the supplier of one type of service off against the other.

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[115]Canada (DIR) v. The D&B Companies of Canada Ltd. (1996), 64 C.P.R. 241.

The Tribunal also dealt at length with the question of product market definition in *Tele-Direct*. The Tribunal took great pains to take into account the reasoning of the Federal Court of Appeal in its *Southam* decision. As is discussed in Section II, the FCA decision in *Southam* was subsequently overturned by the Supreme Court and some of the views it expressed in product market definition were explicitly rejected.

The product market definition issue in *Tele-Direct* was whether the market was confined to advertising in local telephone directories or was broader, encompassing all local advertising.[116] In deciding the issue, the Tribunal relied on the framework for market definition outlined in the *Merger Enforcement Guidelines*. The Tribunal had also relied on this framework in *Southam*.

According to this approach, the process of market definition is essentially one of determining the set of products that can be regarded as close substitutes. In the absence of suitable direct (cross-elasticity) evidence of substitutability of directory advertising with other local advertising, the Tribunal turned to the indirect indicators. The first of these was functional interchangeability. While the Tribunal concluded (and the Supreme Court later confirmed in its *Southam* decision) that functional interchangeability is just one indicator, the question of whether directory advertising and other local advertising are functionally interchangeable received exhaustive consideration. The Director argued that directory advertising differed from other local advertising in that it is a "directional medium" which provides consumers information on goods and services they have already decided to buy. In contrast, other local advertising media are intended more to create awareness of and demand for products and services. In making this argument the Director was assisted inadvertently by evidence provided by Tele-Direct itself. After consideration of this and other evidence (such as timeliness), the Tribunal concluded that directory advertising was not functionally interchangeable with other local advertising.

The Tribunal then turned to other indirect indicators of substitutability. It rejected the argument that inter-industry competition for the same customers put directories and other local media in the same market on the grounds that there was no evidence that one medium had ever modified or improved its product characteristics in response to an initiative from the other, let alone any evidence that customers had either considered such product rivalry to be important or had responded to it. This was the test for inter-industry competition it had applied in *Southam*.

The Tribunal also considered other indirect indicators of substitutability. It properly rejected the " fixed budget" argument which was that if Tele-Direct raised to rates, advertisers with a fixed budget would purchase less directory advertising. The fixed budget argument does not necessarily imply substitutability let alone close substitutability.[117] The Tribunal also noted that although there may have been a group of advertisers who may have been price-sensitive and might leave the directories in response to a rate increase, there was also a substantial number of

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[116]For more detail see Groulx (1997).

[117] A common version of the fixed budget argument is the constant shares argument which is that if the price of one medium rises, customers buy proportionately less of it so as to keep them spending on that medium unchanged. In this case, cross-elasticities of demand between media are zero. Moreover, the own-price elasticity of demand for each medium is one. This implies that a hypothetical monopolist would always find it profitable to raise the price of that medium unless marginal cost were zero.

advertisers who were not price sensitive (who had to be in the directory for competitive reasons) and that directories could separate the price-sensitive from the price-insensitive clients and discriminate against the latter.

Geographic Market Definition

Issues of geographic market definition have been addressed by the Tribunal in *NutraSweet* and *Laidlaw.* In *NutraSweet,* the Tribunal also addressed the question of whether the geographic market should be extended to include foreign producers.

In *NutraSweet*, the Tribunal defined the process of geographic market definition as:

> ... an attempt to determine the extent of the territory where there is competition and in which prices for a product tend to uniformity.[118]

The Tribunal went on to state its *indicia* for geographic market definition:

> In most industries, the absence of governmental trade barriers and low transportation costs is enough to ensure that national boundaries do not create separate markets, particularly where there is easy entry into distribution. Under these circumstances one is usually justified in assuming that sellers (or even buyers) will move product from lower-price areas so that attempts to charge higher prices in any region will be frustrated.[119]

Confronted with a situation in which 100 percent of Canadian aspartame requirements were imported, transportation costs were low and there were essentially no governmental barriers to trade, the Tribunal found, nevertheless, that Canada constituted a separate market "at the level of distribution." The Tribunal cited differences in the average price of aspartame in Canada and Europe (Canada was lower in 1987 and 1988 and higher in 1989) and the existence of country-specific clauses in multicountry country contracts with large buyers as the basis for its decision.

The Tribunal also reasoned that while set-up costs for local distribution may have been modest, NutraSweet's branded ingredient strategy (tying the use of the NutraSweet logo to the purchase of aspartame requirements) served to isolate the Canadian market. Note that the Tribunal has the branded ingredient strategy is doing double duty here. According to its reasoning, Canada is a market because of the branded ingredient strategy and the branded ingredient strategy is anticompetitive because Canada is a market.

In *Laidlaw*, the issue was whether a hypothetical lift-on-board waste disposal monopolist would be constrained by a competitor based 50 kilometres away. Evidence on the matter took the form of a comparison, made by the Respondent on the basis of experience elsewhere in the province, of the incremental cost of providing service to a group of customers from a base 50 kilometres distant with the estimated average revenue (price) per pick-up. The Tribunal rejected this

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[118]Canada (DIR) v. NutraSweet Co. (1990), 32 C.P.R. (3d) 21.
[119]*ibid.* p.21.

evidence on several grounds.[120] First, the evidence was based on experience in a different geographic area that was characterized by greater customer density and probably lower incremental costs of providing service from a distance. Second, the estimated price per pick-up may have been a monopoly price. Distant suppliers might not have been a viable alternative at the competitive price. This is known as the cellophane fallacy. Third, the incremental costs adduced in evidence were those of a dominant incumbent rather than a typical alternative supplier.

Barriers to Entry

The Tribunal examined the question of entry in detail in *NutraSweet.* The Tribunal found that, in addition to a problem of access to a comparable technology, the production of aspartame was also characterized by significant scale economies and sunk costs. This led the Tribunal to conclude that:

> Thus, a firm that hopes to achieve cost parity with NSC must achieve a large market share. Such large scale entry entails significant risks since ... much of the investment in a dedicated aspartame plant is sunk: its value is much less in alternative uses. Another difficulty for would-be entrants is the existence of a marked learning curve in phenylalanine and aspartame production. Even a large, fully utilized plant may not provide costs comparable to those of NSC's present costs until the entrant has accumulated production experience.[121]

Theories of Market Interaction

The task of the Director in abuse cases is to demonstrate that a dominant firm is engaging in exclusionary practices and this, in turn, lessens competition substantially. Put another way, the Director must show that if the order he is seeking is issued, output in the relevant market will be greater and prices lower.

Nielsen provides a good illustration of the analysis of the consequences of the anticompetitive acts alleged by the Director. In this case, the Respondent, Nielsen, had every major supermarket chain under exclusive contract to supply scanner data. As a consequence, Nielsen monopolized the supply of scanner-based tracking services in Canada. Although much of the resulting monopoly profit may have ended up in the hands of the supermarkets in the form of higher prices for their scanner data, the result was still a monopoly in the downstream market (for scanner-based tracking services).

The interesting question in this case is the proximate cause of the monopoly. Nielsen and another company, IRI, had both been bidding for scanner data by offering exclusive contracts to supermarkets. Given the requirement that a tracking service reflect a broad cross-section of supermarkets, a tracking services firm that is unsuccessful in bidding for the scanner data of the

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[120] Canada (DIR) v. Laidlaw Waste Systems Ltd. (1992), 40 C.P.R. (3d) 317.
[121] Canada (DIR) v. NutraSweet Co. (1990), 32 C.P.R. (3d) 27.

largest chains in the country is likely to be at a serious competitive disadvantage in the supply of "national" scanner-based tracking services. A possible result is a knife-edge situation in which dominance in the supply of "national" tracking services is a likely outcome. In this event, the losing bidder(s) would be confined to niche markets (key accounts, specific regions) in Canada until they could bid again on the contracts with the major chains. If one of them successfully outbid the incumbent contractor, the identity of the dominant firm would change. Another possibility is that one bidder might be successful in acquiring the scanner data of one major chain while the data from another major chain goes to another bidder. In this case, each of these two bidders would be in a position to deny the "national" tracking services business to the other. There would be an incentive to cross-license resulting in competition in the supply of "national" tracking services. There might also be a temptation, however, to structure the terms of the cross-licensing agreement might so as to facilitate the joint monopolization of scanner-based tracking services.

It would appear, then, that given the structure of grocery retailing in Canada (i.e. a few very large supermarket chains), exclusive contracting for scanner data may have a tendency to lead to dominance in the supply of scanner-based tracking services. The Tribunal took this view and prohibited Nielsen from entering into exclusive contracts for scanner data.

It has been suggested that in its analysis in *Nielsen*, the Tribunal should have given greater weight to other competitive factors. First, it has been suggested that the users of scanning data had bargaining leverage that would have offset market power in the supply of scanner data. Second, the profits from any monopoly of scanner data would have accrued to grocery retailers and this would have resulted in entry into and expansion of that industry. Third, an order preventing suppliers of scanner-based tracking services from entering into exclusive contracts does not necessarily oblige the supermarkets supplying scanner data to sell their data to all suppliers of tracking services (Collins, 1997). These criticisms are interesting but not compelling.

Efficiencies in Abuse of Dominance Cases

There is an efficiencies defence of sorts in Section 79(4). It states:

> In determining, for the purposes of subsection (1), whether a practice has had, is having or is likely to have the effect of preventing or lessening competition substantially in a market, the Tribunal shall consider whether the practice is a result of superior competitive performance.

One interpretation of this is simply that more efficient firms are not obliged to accommodate or hold an umbrella over less efficient firms. It is not anticompetitive to exclude competitors by producing better products at a lower cost.

Another possible interpretation of Section 79 (4) is that a practice that has exclusionary effects may be justifiable on the grounds that it is efficient. Another way of phrasing this is that some practices may be exclusionary but also have a legitimate (non-exclusionary) business rationale. For example, the fact that a dominant firm is vertically integrated forecloses the market to

potential independent suppliers. Internal sourcing may nevertheless be more efficient than outsourcing for a variety of reasons. The purpose of Section 79 is to ensure that production is efficient rather than to create business opportunities for outside suppliers.

A variation on this theme is that, while a practice may be exclusionary and have no discernible cost justification, it may, nevertheless, be surplus-increasing. This might occur, for example, if a vertically integrated firm squeezes a non-integrated firm by charging a price for an essential input that exceeds its own internal transfer price. This reduces the non-integrated firm's profits and its share of the downstream market. Indeed, if there are economies of scale it may force the non-integrated downstream rival to exit. While this may appear to be a classic case of predatory squeezing, it may or may not result in reduction in economic surplus. The reason is that while there is a reduction in downstream competition, there is also a reduction in what is known as the double mark-up problem (piling market power at one stage of production on top of market power at a subsequent stage) because a greater proportion of the market is supplied by the vertically integrated firm.

This raises an important point with respect to abuse cases. They occur in a context of on-going market power. Remedies that foreclose the exploitation of this power by one means may lead to its exploitation by other, less efficient means.

Efficiency considerations also extend to the long-term. To the extent that dominance is the outcome of a competitive struggle, limiting the competitive strategies available to a dominant firm also reduces the incentive to engage in this struggle in the first place.

More generally, many so-called anticompetitive acts are potentially efficient. The determination of whether they are exclusionary in their effect and surplus-reducing on balance rests heavily on whether a situation of market dominance exists and this is fundamentally a matter of market definition. For this reason it is important to use evidence from sources other than the alleged anticompetitive acts themselves as the basis for defining the market.

Interac

Further discussion of the Interac case is useful for purposes of this study because the case deals with financial institutions, the networks that link them and the regulations that constrain them. It illustrates some of the problems of applying competition law in a regulated environment. *Interac* also relied on the concept of joint dominance, the exercise of market power which the nine charter members of Interac held jointly but not individually. The lessening of competition alleged by the Director involved principally a diminution of product variety and in the pace at which new services were being introduced.

As described by the Competition Tribunal, Interac is an electronic network linking automated banking machines (ABM's), point of sale (POS) terminals and customer accounts at participating (member) financial institutions. At the time the consent order was issued in 1996, Interac had 27 members including nine charter members and 18 sponsored members. The latter were connected to the network through the switch of a charter member.

Interac provides two financial services. The first is shared cash dispensing (SCD) which allows anyone with a debit or credit card issued by a member of Interac to withdraw cash from an ABM operated by another Interac member. The second was Interac Direct Payment (IDP) which allows a customer holding a debit card issued by an Interac member to pay for purchases made from a retailer using a terminal rented to that retailer by an Interac member. Members of Interac may participate as card issuers and (transaction) acquirers or simply as card issuers. A member acquires a transaction when a customer uses one if its ABM's or POS terminals to obtain cash or pay a retailer.

In December, 1995, the Director applied to the Competition Tribunal for an order prohibiting the nine charter members of Interac from abusing their position of joint dominance in the "intermediate" and "retail" markets for shared electronic financial services. The intermediate market was defined by the Director as the market for network services required by a financial institution to give its customers electronic access to accounts at that institution. The retail market was defined to include the shared services that allow a consumer using a card issued by a financial institution to access electronically his/her account at that financial institution either at an ABM or at a POS terminal.

The Director alleged that the charter members (the Respondents) had structured the by-laws and operating regulations of Interac in a manner that substantially reduced competition in the supply of shared electronic financial services in Canada. As the application for the order was not contested, the respondents did not dispute these allegations.

In the Director's view the by-laws of Interac were exclusionary in that they limited participation in the market for shared electronic network services. The by-laws were said to preclude competition among acquirers (there was a commonly agreed upon fee for ABM transactions) and to inhibit product and service innovation (approval of other members was required to offer additional services). The intent of the order sought by the Director was to allow additional financial institutions and others to connect directly to Interac. In attempting to improve access to Interac and to increase competition among it's members the Director implicitly gave up on a number of alternatives including the creation of a competing shared electronic financial services network.

The terms of the consent order were such as to require that direct connection with Interac be open to all commercial firms as acquirers (owners of ABM's or POS terminals). Direct connection with Interac as a card issuer was to be open to all financial institutions, that is, all members of the Canadian Payments Association (CPA). The Interac board retained its authority to establish reasonable criteria for direct connection by either acquirers or issuers.

The consent order also changed the terms of eligibility for indirect connection (that is, connection through the switch of a direct connector). In particular, Interac members were no longer restricted from allowing non-CPA members indirect access to Interac. Under the terms of the order, a direct connector would be allowed to work out an arrangement with, say a brokerage firm or an insurance company which would allow clients of non-CPA members such as these to access funds invested with them via Interac.

The consent order also addressed the governance structure and operating rules of Interac. Board representation was to expand. Charter members would no longer be in a position to block new service offerings by individual members. The order further limited Interac's sources of revenue to a single switch fee to be changed on a per message basis.

In its consideration of the effectiveness of the consent order in remedying the lessening of competition identified by the Director, the Tribunal questioned the Director's choice of remedies. The Tribunal asked why the Director did not consider seeking an order requiring Interac to clear transactions among its members outside the CPA. This would have freed Interac from CPA rules and would have enabled non-CPA members to become direct connectors as both acquirers and issuers, an outcome the Tribunal appeared to regard as preferable to the solution proposed by the Director. The Tribunal also recognized, however, that the Director faced a dilemma. An order requiring Interac to clear transactions outside the CPA would have been contested and the regulated conduct defense would have been raised. The question was how far the Director could have pushed the regulatory and public policy envelope.

With some reluctance, the Tribunal accepted that it would have to assess the adequacy of the consent order in remedying the lessening of competition identified by the Director given that all concerned would continue to be governed by CPA rules. The Tribunal accepted that the order would open up Interac membership to about a hundred other CPA members on virtually the same terms as had existed for charter members. The Tribunal noted that it had no evidence as to how many wanted to join.

The Tribunal found that the proposed easing of the requirements for introducing new services could accelerated the rate of innovation in bilateral/multilateral services although it was not likely to have any effect on shared services.

With respect to the provisions of the order allowing for connection to Interac. by acquirers who are not CPA members, the Tribunal was skeptical. It noted the means by which brokerage firms were able to offer their clients access to money market funds via VISA or Mastercard in the United States. It found that Canadian attempts to imitate this service had not been successful at least in part because they required the customers of the non-CPA members involved to maintain an account with a CPA member as well. It was not clear to the Tribunal whether CPA rules would allow for arrangements which did not require customers seeking electronic access to their accounts with non-CPA members to open an account with a CPA member as well.

The consent order issued by the Tribunal in Interac has been in place for a year and a half. In that brief time, Interac membership has expanded and it now includes non-financial institutions. There are new acquirers in both shared cash dispensing and POS terminals. As yet, however, there are no new shared services or emerging subnetworks.

Conclusions

The purpose of this brief survey of Canadian experience with the abuse of dominance provisions of the *Competition Act* is to determine whether they are likely to be effective in encouraging competition in the financial services industry. It is important to understand the purpose of the

abuse provisions of the Act. They are not intended to regulate the prices or quality of service provided by a dominant firm. Charging high prices or providing indifferent service are not themselves anticompetitive acts.[122] Those seeking free access to banking services or penny a loaf bread will have to rely on other policy levers. The purpose of the abuse provisions is instead to prevent a dominant firm or group from excluding new entrants or smaller rivals who would otherwise compete down prices or improve service. It is difficult to get this right. It is not anticompetitive for a dominant firm or group to exclude new competitors by providing better service or lower prices. The Tribunal saw this clearly in *Tele-Direct*. It is exclusion by means other than superior competitive performance that is potentially anticompetitive. The distinction can be a difficult one to draw. There are practices with a legitimate business (efficiency) justification that are also exclusionary. Balancing the two is problematic.

Insofar as the application of the abuse provisions of the Act to the financial services industry is concerned, there is reason for optimism. The Tribunal has dealt with a major case involving the financial services industry. The proceeding did not lack for industry-specific expertise. Many of the competition issues which have been a source of concern to various participants in the financial services industry have been raised by the Director and addressed by the Tribunal. These include the joint exercise of market power by a dominant group, the diminution of non-price competition, the inability of some, identifiable subgroups of customers to switch suppliers and the definition of local markets. At the same time, however, the limitations imposed by various forms of financial sector regulation on the application of competition law to it have become readily apparent.

More generally, enforcement of the abuse provisions of the *Competition Act* has been relatively active and the Director has been largely successful in obtaining the remedial orders he has sought. Both the Director's approach and the Tribunal's decisions have been victim-friendly, frequently equating the fortunes of excluded entrants with the state of competition. Remedies have been quite bold in some cases although not in all. This should provide some comfort to those who fear increased exclusionary activity as a result of increased concentration of financial services markets. There is a limit, however, to the number of cases the Director can take. As was suggested in Section VIII in connection with tying arrangements, concerns of this nature could be alleviated by providing for a private right of access to the Competition Tribunal in abuse of dominance cases.

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[122]Of course, an agreement among substantial competitors to increase prices or reduce service quality would be an offence under section 45 of the Act.

X. Conclusions

Questions and Answers

(1) In view of the Hillsdown and Southam cases, are the merger provisions of the Competition Act (CA) adequate to provide effective merger control in the financial services area, particularly if the government abandons its policy directive that "big shall not buy big"?

The experience with merger review under the CA has been discussed at length in section II. Of the two litigated cases referred to above, the Director lost one (*Hillsdown*) and won a part of the second. While the remedy granted by the Competition Tribunal in *Southam* involved a significant divestiture, the divestiture has yet to occur and the case is in its eighth year. On the basis of the litigated cases it would not be unreasonable to conclude that the *Competition Act* has not been a very effective weapon against anti-competitive mergers.

The effectiveness of the CA in discouraging anti-competitive mergers cannot be judged solely on the basis of the two litigated cases. The examination of the entire experience with merger review under the CA leads one to conclude that the CA has not been ineffective in discouraging anticompetitive mergers although it could probably have been more effective than it has been. The CA is clearly in a different category than its predecessor, the Combines Investigation Act (CIA). Insofar as merger review was concerned, the CIA was a demonstrable failure, principally because, as criminal law, it required proof beyond a reasonable doubt that a merger was detrimental to the public interest.

When account is taken of proposed merger transactions that are abandoned either in anticipation of the Director's reaction or after consulting with the Director and of mergers that are restructured as a result of either undertakings to the Director or consent orders, it becomes clear that the merger review process is effective and can reasonably be expected to protect markets from mergers to monopoly or to dominance.

Predictions with respect to the likely response by the Director and the Tribunal to mergers in tight oligopoly (small numbers) situations are somewhat more hazardous. The Director has, on one occasion, required divestitures sufficient to keep the merged entity's pro forma market share below 25 percent in markets in which he thought competitive forces were weak. On other occasions, the Director has apparently been satisfied with a situation in which the merged entity's market share approached 50 percent. The Director's response to a proposed merger depends of course on the Section 93 factors but is also conditioned, in part, by the existing market situation, by the remedies available and by his own limited resources. In a market in which the Section 93 factors are unfavourable and customers are small and not able to behave strategically, the Director might well have serious concerns about a merger involving pro forma market shares in excess of 25 percent if it created a new largest firm in the market. The Director's actual response would depend, however, on the nature of the remedies available.

The second part of the question is whether the application of the CA as described is sufficient to discourage anticompetitive mergers in the financial services industry. The question here is whether the financial services industry in general and banking in particular require a higher standard of merger review than other industries. Banking has its unique characteristics. So do most other industries. The question is whether the method of merger analysis used in all other industries (including industries subject to various forms of regulation) should be applied largely unchanged to the fact situation existing in banking as the Competition Bureau proposes to do.

The United States and Australia are two countries with similar traditions to Canada which have also confronted this question explicitly. They have unambiguously adopted the approach of analyzing the competitive consequences of banking mergers using exactly the same methodology as they use in the review of mergers in other industries. The implication is clear. Insofar as the applicability of the tools and concepts of conventional merger analysis is concerned, banking does not differ appreciably from other industries. It is important to understand that this is not to say that banking does not differ from petroleum refining or flour milling. There are very important differences in the respective characteristics of these industries. What it does say is the analytical framework of merger review is sufficiently general that it can applied to the fact situations as they exist in each of these industries.

While not disputing the relevance and transferability of such concepts as barriers to entry, product substitutability and intensity of import competition, it may nevertheless be argued that different market concentration thresholds are required in banking than in other industries. In the simplest terms, the argument is that while competition among, say, four flour mills might be workable, competition among four banks would not. If competition authorities relied solely on a bright line market concentration or market share rule this would indeed be a concern. But this is precisely what the Section 93 factors are designed to deal with. It is indeed important that the nature of competitive interaction, including such factors as transparency of (posted) prices, the role of service competition, the size of customers and the costs of breaking longstanding relationships (switching) be taken into account and the merger review process in Canada is designed to do precisely this.

While there appears to have been a full recognition by the antitrust authorities in Australia and the United States of the frictions that can exist in retail banking markets, this has not led, in Australia, to any change in the market share and concentration thresholds applied in banking mergers. In the United States, the market share and concentration thresholds applied in banking mergers are more generous, in terms of the increase in market concentration they will tolerate, than is the case for other industries. This reflects a recognition that there are suppliers of retail banking services other than banks generally active in most local markets and that there are a number of other factors generally at play the net effect of which is to *mitigate* concerns about the exercise of market power at any given level of market concentration. Even so, a merger resulting between banks each with 12 percent or more of any local banking market with six or fewer banks in it would run into serious difficulties in the United States. The key issue for the United States antitrust agencies has not been whether banking is different than other industries but what financial institutions supply or could supply the major retail banking services, especially small business loans.

The implication of all this is that different analytical methods or market share/concentration thresholds are not necessary to deal with bank mergers in Canada. What is necessary is a clear understanding of the markets involved, that is, of the alternatives available to users of retail banking services and their ability to avail themselves of them.

(2) Do the provisions of paragraph 94(b) of the CA (which effectively permit the Minister of Finance to pre-empt Competition bureau review of a merger under the Bank Act, the Trust and Loan companies Act or the Insurance Companies Act where he certifies to the Director under the CA that "the merger is in the best interests of Canada") constitute a sufficient or satisfactory method of reconciling possibly conflicting regulatory considerations in the merger review process, as compared with possible alternatives such as:

(a) concurrent regulatory review; or

(b) merger review solely within the purview of the financial industry regulator with the Director presenting the Bureau's views for consideration by the financial industry regulator.

In this connection, bearing in mind that the Director's sole focus is on the competition effects of the merger, are there inherent conflicts between the objective of fostering competition on one hand, and protecting financial system stability on the other? If such conflicts exist, how should the regulatory/legislative regime attempt to reconcile them?

As is explained above, the methods of assessing the likely anticompetitive effects of a proposed merger under the present merger review process are sufficiently general and flexible to accommodate mergers among banks. A specialized financial industry competition regulator would have nothing new analytically to bring to the table. A specialized financial industry competition regulator would be redundant. There should be one competition regulator and this regulator should be pre-eminent in competition matters. This is the approach taken in Australia. This is not to say, however, that the Competition Bureau necessarily has the resources required to analyze the many and complex competition issues that are likely to emerge in a merger of Schedule I banks. The Bureau and the Tribunal must have ready access to the appropriate institutional expertise whether it resides in other government agencies or in the private sector.

While it is difficult to see any benefits from parallel competition assessment of bank mergers, this is the approach taken in the United States. In the United States there is concurrent assessment of banking mergers by the relevant banking regulator and the Department of Justice (DOJ) and there are, as well, statutory provisions which limit or could limit banking mergers themselves. Insofar as concurrent competition assessment of bank mergers is concerned, the competition assessment of the banking regulator appears to be totally redundant. Both the banking regulator and the Department of Justice use the same information and virtually the same assessment criteria and come to the same conclusion. The banking regulator does not bring an industry-specific view or mode of analysis to the process. Indeed, the DOJ is tougher, if anything, than the banking regulator especially with regard to its concern that divestitures serve the interests of small business customers. There is nothing in the U.S. experience to imply that there are any benefits from concurrent competition assessment or that the responsibility for merger review should lie other than with the antitrust regulator.

The United States does have statutory provisions limiting the bank holding company size nationally to 10 percent of deposits and allowing states to limit the deposit shares of bank holding companies to 30 percent or less if they choose (and some states have chosen to do so). States can also forbid interstate branching and Texas has apparently done so. In addition there is also a specific statutory prohibition against tying by bank holding companies (this is dealt with below). The question is whether this legislation implies a view that additional restrictions are required on potentially anticompetitive mergers and trade practices by banks, that is, that traditional competition law is somehow not enough. The statutory deposit share limitations are not binding in many instances. The national 10 percent ceiling is not binding. Most banking mergers would run into antitrust trouble before they approached the 30 percent ceiling on state deposit shares. The ceilings may have been motivated by concerns about other issues. States may wish to deter the entry of out-of-state banks. This is obviously a non-issue in Canada. Insurance companies have also opposed interstate banking. Limitations on interstate bank expansion may have been more to protect competitors than competition. In sum, there is little to indicate that these statutory deposit share ceilings are an effective or important adjunct to the merger review process as it relates to banking in the United States.

A recommendation that the Competition Bureau and the Competition Tribunal should be pre-eminent in the assessment of the impact of bank mergers on competition in banking markets does not imply that other regulators have no role or that coordination is not necessary. The prudential regulator has a role. While this is a matter for others, arguments that increased bank concentration causes problems for prudential regulation (too big to fail) do not appear to have been persuasive to those who have examined them (the Wallis Inquiry, for example).

While it is unlikely that a lessening of competition would itself pose a problem for the prudential regulator, the latter may have occasion to challenge a merger on other grounds (unsuitability of one of the firms involved) or to require a merger to forestall a financial collapse. This poses interesting problems. Should the prudential regulator have an absolute override with respect to prudential issues (in which case the Director withdraws as soon as prudential concerns are made known) or should there be a trade-off? For example, should a failing bank be sold to the first bank willing to acquire it or should it be shopped around until the possibility of a less anticompetitive rescue package exhausted? Should the prudential regulator at least be required to entertain submissions from the Director regarding the possible anticompetitive impacts of proposed rescue packages? In this limited sense, there may be a trade-off between competition and financial system stability. Whatever path is ultimately chosen, the present situation in which it is not known when and how prudential regulatory concerns would enter the merger review process is unsatisfactory.

If other regulators are also given a role in reviewing Schedule I bank mergers, similar coordination problems may arise with them. In the event that the imposition of Investment Canada style “benefits to Canada” tests or job preservation undertakings are, for some reason, imposed on Schedule I bank mergers, the question arises as to whether considerations of this nature should be allowed to overturn the decisions of the Competition Bureau. This would be discriminatory in that these factors are not among the merger assessment criteria under the CA and need not be met by mergers in other industries. Imposition of requirements of this nature would also be an unfortunate course of action in that past attempts at job “creation” by regulation

have been a demonstrable failure. Nevertheless, if such requirements are imposed, the question of whether, in the event that there is a conflict, they override or trade-off against competition decisions must be addressed.

(3) Is there a need in financial services industry cases to take special account of efficiencies, beyond that provided by the CA's efficiency defence in a merger case (i.e., to consider efficiencies generated by a merger as one of the assessment criteria even when the efficiencies, in aggregate would be insufficient to invoke a section 96 defence)? If so, should such efficiencies only be considered when they are likely to be passed through to, and thus benefit, consumers? What conditions will ensure that this flow of benefits occurs?

The efficiency defence under Section 96 of the CA should provide an adequate basis for defending a merger that increases efficiency but also increases market power. It has been suggested from time to time that efficiency gains should also be considered as a Section 93 factor in merger evaluation in that the achievement of efficiency gains provides a motive for merger other than the pursuit of market power.[123] Efficiency gains are important in merger assessment in the indirect sense that the larger are efficiency gains the less likely it is that the merger involved is profitable because it increases market power and market power stories can be weighted accordingly.

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[123] Efficiencies could be considered as another factor under Section 93(h). Recall that Section 93 of the CA reads as follows:

In determining, for the purpose of section 92, whether or not a merger or proposed merger prevents or lessens, or is likely to prevent or lessen, competition substantially, the Tribunal may have regard to the following factors:

(a) the extent to which foreign products or foreign competitors provide or are likely to provide effective competition to the businesses of the parties to the merger or proposed merger;

(b) whether the business, or a part of the business, of a party to the merger or proposed merger has failed or is likely to fail;

(c) the extent to which acceptable substitutes for products supplied by the parties to the merger or proposed merger are or are likely to be available;

(d) any barriers to entry into a market, including;

(i) tariff and non-tariff barriers to international trade,

(ii) interprovincial barriers to trade, and

(iii) regulatory control over entry,

and any effect of the merger or proposed merger on such barriers;

(e) the extent to which effective competition remains or would remain in a market that is or would be affected by the merger or proposed merger;

(f) any likelihood that the merger or proposed merger will or would result in the removal of a vigorous and effective competitor;

(g) the nature and extent of change and innovation in a relevant market; and

(h) any other factor that is relevant to competition in a market that is or would be affected by the merger or proposed merger.

Efficiency gains should confront increased market power directly in Section 96. Whether Section 96 will ultimately be interpreted so as to allow a full comparison of all surplus-increasing and surplus-decreasing effects of a merger remains to be seen. There are two issues here. The first is whether all efficiency gains made possible by a merger are cognizable, that is whether they are admissible for comparison with market power effects and thus "count" in favour of the merger. Profits on foreign business gained or retained as a result of a merger are one of the benefits of it and should count in its favour. There is some uncertainty as to whether the Director would do this at present.

The second issue is whether the efficiencies defence will ultimately involve a simple balancing of the positive and negative effects of a merger or whether it will require the benefits of a merger be such that nobody in Canada is worse-off as a result of the merger. It appears as if the Competition Tribunal interprets the CA as requiring it to disallow a merger that makes a group of Canadian customers worse off even if it makes Canadian shareholders better off by a much larger amount. Under this approach, whatever benefits a merger may have insofar as increased or retained foreign business is concerned would not be considered. Adherence to this approach carries with it the risk that merger assessment under the CA may be overridden by the Minister on competitiveness grounds. If increased surplus resulting from a merger and accruing to Canadians counts in its favour regardless of source, a competitiveness assessment is redundant. If CA assessment is to be paramount in competition matters it cannot ignore some of the increases in surplus accruing to Canadians as a result of a merger.

(4) Are concerns that the consummation of a proposed merger may facilitate the merged firm engaging in collusion, cross-subsidization, discriminatory pricing, tied selling, exclusive dealing, and other arguably anticompetitive practices sufficiently met by the response that there are other specific provisions in the CA to deal with such matters if and when they arise?

The possibility that a proposed merger will facilitate interdependent behaviour is one of the more important concerns in merger review. Both the Canadian and the U.S. merger guidelines contain discussions of the warning signs that a market may be vulnerable to collusive behaviour. In the United States, a bank merger resulting in an increase in the HHI of 250 points to a level in excess of 2,200 would encounter serious problems at the Department of Justice. Roughly speaking, absent huge efficiencies, further consolidation of a local banking market served by five roughly equal-sized banks would not likely be tolerated in the United States. This reflects a concern that collusion would become a distinct possibility if the market were allowed to become any more concentrated. This is, however, a qualitative judgement rather than a quantitative one.

Although merger guidelines focus on the interdependent exercise of market power in oligopoly situations, there are widely accepted oligopoly models that predict adverse price and output consequences of mergers in tight oligopoly situations *in the absence of any increase in interdependence.* In addition to being the mainstay of academic analysis of merger policy, these models certainly influence to thinking of economists in antitrust enforcement agencies.[124] It

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[124]Merger simulation models making use of non-cooperative oligopoly models can be found on the Canadian competition policy web site at UBC and at the antitrust policy web site at Vanderbilt University.

would be incorrect to infer that the Director would have no grounds to oppose a merger falling short of dominance either because of the relative lack of precision of the interdependence paradigm or because the conditions for successful collusion are not present.

While merger review does not proceed on the assumption that any joint action facilitated by a proposed merger would be deterred by legal prohibitions against horizontal restraints, the existence of effective prohibitions against collusive behaviour makes the task of merger review easier. Since there is no bright line at which successful collusion becomes a virtual certainty, the existence of an effective prohibition of horizontal restraints allows the merger review process to give the merging firms the benefit of the doubt. While an assessment of the law and jurisprudence on horizontal restraints in Canada must be left for others, it is apparent that there have been difficulties in the past. The Supreme Court decision in *PANS* has, however, established a firm foundation for and provided a clear interpretation of the law in this area. Explicit collusion among banks, even among a subset of them would probably run afoul of Section 45 as it is now interpreted and would also be covered under Section 49. As the Competition Bureau's submission to the Task Force has made clear however, independent decisions to adopt the same prices, conditions of sale or other trade practices (often called conscious parallelism) would not be covered under Section 45. Parallel adoption of practices that have the effect of excluding new entrants thereby lessening competition substantially might still be covered as an abuse of joint dominance under Section 79.

Discriminatory pricing is prohibited in Canada only when it is predatory (Sections 50(1)(b) and (c)) and when it involves the sale of like qualities and quantities of a product to *competing* customers at different prices (Section 50(1)(a)). Prosecutions and private actions under these sections of the CA are extremely rare. The Competition Tribunal recently confirmed in *Tele-Direct* that charging lower prices in more competitive markets and higher prices in less competitive markets (competing where there is competition) is not an abuse of dominance.

Discriminatory pricing is so common it generally goes without notice. Indeed, the ability of a customer to use whatever knowledge and alternatives available to him to bargain for discounts off posted prices is widely and rightly believed to be an indicator of the vitality of competition. For example, the ability to shop around for discounts off posted interest rates on mortgage loans is frequently adduced as evidence of competition among banks and other lenders in the mortgage market.

In general, discriminatory pricing may either include customers who would have been excluded under non-discriminatory prices or exclude customers who would have been included under non-discriminatory prices. Which outcome is the more likely is difficult to determine. Given the high probability of getting it wrong, competition law has wisely stayed out of the matter unless discrimination is also predatory.

The possibility of price discrimination does, however, remain a consideration in merger review. Some customers in a market may have better alternatives than others. The merged entity may acquire no market power vis à vis its more mobile customers but may be able to charge higher prices on a sustained basis to other customers who have fewer alternatives. In this case, the immobile customers may be treated as a distinct product market and a proposed merger may

stand or fall on it consequences for customers in that market. This is, of course, the rationale for the distinction between retail and wholesale banking. Within the retail banking market, there may be further distinctions based on the ability of customers to avail themselves of alternatives to the merged entity. The emphasis placed on small business retail banking customers by the DOJ in its review of bank mergers in the United States reflects a recognition of the possibility that small business customers may be vulnerable to discrimination. The Competition Bureau has indicated in its submission to the Task Force that it intends to take a similar approach in its analysis of Schedule I bank mergers.

Tying and exclusive dealing are reviewable practices under Section 77 of the CA. They may also be covered as abuses of dominance or joint dominance under Section 79 of the CA. At present there is no provision for private actions under these sections although there is pressure to introduce such a provision. While there have not been many cases, the interpretation of Sections 77 and 79 of the CA by the Competition Tribunal must be regarded as being exceedingly victim friendly. Tying and exclusive dealing become matters of concern if they extend or entrench market power. Tying does not do this frequently. Most frequently tying is a means of price discrimination (see above). The Competition Tribunal may be prepared to limit tying which hurts *a competitor* even though it does not extend market power and does not reduce *competition.* Financial service firms that see themselves as victims of tying or exclusive dealing arrangements by Schedule I banks or other should take comfort in this.

The possibilities for tying are so varied and so numerous that arguments that a merger might increase the opportunities for tying are not frequently made. A related argument to the effect that a merger may foreclose either sources of supply or outlets for non-integrated firms is commonly made and it is considered as one of the manifestations of market power in one of the markets in which the merged entity operates.

(5) In merger cases involving financial institutions, is the concern about the increased potential for collusion (due to the reduced number of competitors resulting from the merger) sufficient to warrant intervention at a lower level of market concentration than would appear to be reflected in the Bureau's present merger enforcement approach (i.e. should there be some less onerous requirement for challenging a merger of financial institutions than satisfying the present requirement of showing that the merger will substantially prevent or reduce competition in a relevant market)? If such analysis is prompted by the perception that the products supplied by these institutions are essentially homogeneous and largely substitutable as between institutions, is this perception factually based?

Some of this question has been dealt with above. While the Director has acquiesced in some mergers in some relatively concentrated markets, it does not follow that he would necessarily acquiesce in the emergence of a much more concentrated banking industry. The Merger Enforcement Guidelines indicate that the Director may have concerns about the interdependent exercise of market power where the pro forma market share of the merged entity is as low as 10 percent if the largest four firms in the market account for at least 65 percent of it. The Director's submission to the Task Force stated that he would use this threshold (plus the 35 percent threshold for unilateral exercise of market power) when dealing with bank mergers. In this he is joined by Australia and the United States. Australia uses the same thresholds for

bank mergers as it does for other mergers. The United States uses a more liberal threshold but this is intended only to compensate for some errors in measuring market shares. It does not reflect any belief that a given level of market concentration implies something different about competition in banking than it does about competition in other industries.

Of course the guidelines are just that and they do not bind the Director. He could voice concerns at a lower threshold. As suggested above, other widely accepted oligopoly models predict adverse price and output consequences of mergers falling short of dominance even though there is no increase in interdependence. The most recent (1992) U.S. horizontal merger guidelines can be read as implying a willingness to follow this approach in addition to the traditional unilateral market power/interdependence approaches.

The Director has, on the other hand, accepted fairly high levels of domestic producer concentration when the Section 93 factors have been favourable. It is not particularly fruitful to discuss market share and concentration thresholds in isolation from the Section 93 factors. If they are favourable, competition may be workable with relatively high levels of market concentration. If they are unfavourable, even a relatively small increase in concentration may be a matter of serious concern.

This response really begs the question. Are the Section 93 factors likely to be favourable or unfavourable in banking markets? This requires the type of detailed analysis that accompanies an actual merger proposal. Conclusions are likely to vary from product market to product market. For the United States antitrust authorities, the supply of retail banking services to small business is problematic. In a recent Australian merger, the concern was with the effect of the merger on competition in the supply of transaction (chequing) accounts and related services. It is not unreasonable to expect that the same concerns will be among the most pressing competition issues arising as a result of mergers between Schedule I banks in Canada.

(6) In financial service sector mergers, what is the most appropriate method for defining the product and geographic dimensions of relevant markets affected by such mergers having regard to specific characteristics of wholesale and retail financial services and the rapid technological changes impacting the industry? In this connection, to what extent are cluster and multi-product markets useful analytical tools?

The paradigm for market definition is the hypothetical monopolist test. It is important to understand that this is more a convenient way of thinking about market definition than a method that can be applied literally. It suggests, in essence, that the market definition exercise begin with a narrowly defined market and, if warranted, expand it. The expansion criterion is whether the customers within a market have good alternatives outside it. If they do, the market is too narrowly defined and it should be expanded. Geographic markets for many retail banking services are likely to be local although a local market may encompass an entire metropolitan area. Product markets may be defined in terms of individual lines of business for some sets of customers and combinations of product lines (clusters) for other groups of customers. "One stop shopping" markets are routinely defined in merger cases involving distribution and service businesses. Due recognition will have to be given to arguments that traditional product lines

such as mortgage lending are better viewed as rapidly evolving bundles of services and it may ultimately be these component services that matter.

(7) To what extent does consummation of one merger create pressure/justification for further mergers in the same markets by providing other industry participants with an argument that they too should be allowed to merge to achieve sufficient scale to compete effectively with the newly merged firm?

Consummation of one merger may will lead to other merger proposals. The nature of subsequent merger proposals may depend on the characteristics of the first merger allowed. In one sense subsequent merger proposals will have a more difficult time of it in that the relevant markets will have become more concentrated as a result of prior mergers. On the other hand, proponents of subsequent mergers may be able to argue that their mergers would make them stronger competitors. Strong arguments can indeed be made in support of mergers among the smaller firms in a market.[125]

(8) Are the CA's remedial provisions relating to such matters as tied selling too weak or too slow to control such practices/behaviour in the financial services sector?

Tied selling is ubiquitous and only rarely is it used for the purpose of extending market power. The Director has the authority to challenge tying for the purpose extending market power. The Tribunal has shown a willingness to infer an extension of market power on the basis of adverse consequences for individual competitors. Firms perceiving themselves to be victims of tying arrangements by competitors should take comfort in this. At the same time, the Director is limited in the number of tying cases he is able to take. It is probably not among his highest priorities and rightly so. There has been one contested tying case under the CA. This may be because this is simply not a serious problem insofar as its effect on the competitive process is concerned or it may be that the Director has insufficient resources to deal with tying complaints. Provision for private access to the Tribunal, at least for injunctive relief, would address the perceived problems of aggrieved competitors. It would not necessarily be the answer for consumers. The imposition of ancillary tying prohibitions as in the (not yet proclaimed) amendments to the Bank Act is not the way to go. There is no reason to single out banks. There is no reason to prohibit ties that cannot be shown to lessen competition. U.S. experience has been that the anti-tying provision in the Bank Holding Company Act is used largely as a tactical weapon either by competitors or in lender-borrower negotiations. While some may wish to handicap some of the players in the market in the mistaken view that this somehow levels the playing field, they have no grounds for arguing that this contributes to the vitality of the competitive process.

Tying is frequently for the purpose of price discrimination. Price discrimination can be socially beneficial and it is not against the law unless it is predatory. By definition, however, some pay higher prices and some pay lower prices with price discrimination than if there were none. Those who pay higher prices will argue that price discrimination is a bad thing and it is for them. The

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[125] See Farrell and Shapiro (1990), MacAffee and Williams (1992) and Werden and Froeb (1994).

beneficiaries may remain silent. The key question is whether, in aggregate, price discrimination is better or worse than the alternative. The alternative may be a constant mark-up for all customers. There are many situations in which this would leave consumers and producers in aggregate worse off.

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